

MODERNIZATION OF US ASSET MANAGEMENT REGULATION

MARCH 2016

“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.”

— Mary Jo White, SEC Chair, December 11, 2014

In December 2014, Securities and Exchange Commission (SEC) Chair, Mary Jo White, laid out an ambitious program for modernizing the regulation of US registered mutual funds and investment advisers.¹ Her speech referenced initiatives for collecting additional data to enhance the SEC’s existing surveillance capabilities, finalizing rules for the use of derivatives in mutual funds, introducing liquidity risk management standards and stress testing for funds, and addressing the transition of client assets in the event of an asset manager winding down. This broad agenda reflects the continuation of work by the SEC to modernize and re-evaluate how the SEC regulates the asset management industry in the post-Crisis era.

The SEC effort began with the rulemaking to require certain private funds to register with the SEC and report data on various portfolio attributes on a regular basis to the SEC through Form PF. More recently, the SEC finalized reforms for money market funds, which are nearing their final implementation date in October 2016.² Today, the SEC is continuing this work with a particular focus on US registered investment advisers and US registered funds. In particular, the SEC has released four proposed rules and one request for comment in the past year, all related to modernizing existing regulations and incorporating several new pieces of regulations.³ The Investment Advisers Act of 1940 and the Investment Company Act of 1940 (1940 Act) are the two key pieces of legislation governing US registered investment advisers and US registered funds, respectively. Since 1940, the SEC has provided a series of interpretive guidance, exemptive orders, and rulemakings to address issues as they arose. Taken together, the current modernization initiative is significant both for its breadth and for its focus on both investor protection issues and systemic risk concerns.

GUIDING PRINCIPLES FOR MODERNIZING REGULATION

1. Take a holistic approach to the package of rules that are in process to ensure consistency and alignment in the collective outcomes.
2. Endeavor to harmonize data reporting and certain definitions with global standards and existing rules for other investment products and practices.
3. Develop a comprehensive ETF rule focusing on the risks specific to ETFs.
4. Ensure that the fund board’s role of oversight (not day-to-day management) is preserved in all rules.
5. Calibrate sufficient implementation timeframes for each rule, recognizing the complexity of the new requirements and potential overlapping implementation periods under the package of new regulations.

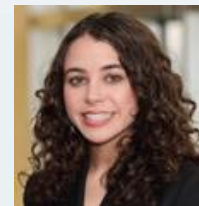
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“BlackRock supports financial regulatory reform that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice, assessing benefits versus implementation costs, and maintaining a level playing field across products.”

BlackRock supports financial regulatory reform that increases transparency, protects investors, and facilitates responsible growth of capital markets while preserving consumer choice, assessing benefits versus implementation costs, and maintaining a level playing field across products. BlackRock has provided thought leadership on a wide range of regulatory reform issues based on these guiding principles. We believe it is important to modernize rules governing mutual funds and their advisers and we support the SEC in its efforts to do so. In October 2014, we published a document entitled [Financial Regulatory Reform: Looking Forward](#), which laid out areas related to asset management products and activities that warranted further study. Subsequently, the Financial Stability Oversight Council (FSOC) issued its [Notice Seeking Comment on Asset Management Products and Activities](#) in December 2014. The FSOC request for comment included questions on four topics: (i) liquidity and redemptions; (ii) leverage; (iii) operational risk; and (iv) resolution. BlackRock, along with many others, submitted feedback on the FSOC request for comment. In our [comment letter](#), we made several key recommendations on areas of asset management regulation that deserved further attention.

In particular, our comments to FSOC and in many other publications have focused on:

- 1. Filling data gaps** to enable regulators to oversee and monitor risks. We view data as a means of addressing speculation about the risks associated with asset management products and activities and to ensure that regulators’ attention is focused on addressing real and quantifiable risks and that policy decisions and policy measures are data driven.
- 2. Raising the bar on liquidity risk management** across the industry to ensure that all funds are appropriately managing liquidity and redemption risk. This concern was heightened by the issues experienced by the Third Avenue Focused Credit Fund in December 2015.
- 3. Broadening the fund “toolkit”** to enable fund managers sufficient flexibility to address “tail-risk” redemption situations.
- 4. Harmonizing the regulatory definitions of leverage globally** to reduce inconsistencies between various regulations and to facilitate global monitoring of risks.

This *ViewPoint* reviews the SEC’s ongoing regulatory agenda with respect to asset management products and activities. We support the goals of the rules that have been proposed thus far and believe that many of the rulemakings address the suggestions made to FSOC on improvements to the regulation of the asset management industry that would be beneficial from both an investor protection and systemic risk perspective. The SEC’s decision to proceed via formal rulemakings in many cases is helpful, as soliciting feedback from practitioners is key to ensuring that the rules accomplish their objectives without unintended consequences. We have used the opportunity to comment to indicate both our support

Exhibit 1: SEC AGENDA FOR MODERNIZATION OF US ASSET MANAGEMENT REGULATION

| Rule Proposal | Status | Date Proposed | Date Comment Period Closed | # of Pages* |
|---|-----------------------|---------------|------------------------------------|---|
| Data Reporting - Investment Advisers | PROPOSED / NOT FINAL | 6/12/2015 | 8/11/15 | 103 |
| Data Reporting - Mutual Funds | PROPOSED / NOT FINAL | 6/12/2015 | 8/11/15; re-opened through 1/13/16 | 510 |
| Exchange-Traded Product Request for Comment | NO NEW RULES PROPOSED | 6/17/2015 | 8/17/15 | 51 |
| Liquidity Risk Management | PROPOSED / NOT FINAL | 10/15/2015 | 1/13/16 | 415 [+ 52 pp. DERA Study] |
| Derivatives | PROPOSED / NOT FINAL | 12/28/2015 | 3/28/16 | 421 [+ 97 pp. DERA Study] |
| Stress Testing | NOT YET PROPOSED | - | - | - |
| Transition Planning | NOT YET PROPOSED | - | - | - |

* Page counts reflect SEC version of proposals, not Federal Register. DERA = SEC Division of Economic and Risk Analysis.

for and concerns with specific aspects of the proposals. In some cases, we have suggested alternative approaches to better achieve the intended outcomes. At this juncture, we believe it is equally important to look at all of the proposals as a complete package as opposed to isolated rulemakings, as each of the final rules will need to operate in a coordinated fashion to collectively achieve the SEC's objectives. In the following sections, we provide a synopsis of each of the proposed rules and highlight key recommendations from our response letters.

In the last year, the SEC has proposed four new rules addressing registered advisers and mutual funds and has undertaken a review of exchange-traded products (ETPs). In addition, we anticipate that at least two additional rules will be proposed as part of the SEC's modernization initiative. None of the rules have been made final and the timing to completion is uncertain. As part of the normal rulemaking process, we anticipate that the SEC will make changes to these proposals in response to the comments it has received. In this section, we review the highlights of each of the proposed rules.

Amendments to Form ADV and Investment Advisers Act Rules

Reflecting the need to update data reporting requirements, on June 12, 2015, the SEC proposed [Amendments to Form ADV and Investment Advisers Act Rules](#) (Form ADV Proposal). Form ADV is an annual form that must be completed by all registered investment advisers. The form includes information about the registered investment adviser, its business, its assets under management (AUM), and many other points of information about the adviser. Through this rulemaking, the SEC is increasing the amount of data reported on Form ADV, including data about separately managed accounts.⁴ In particular, the SEC requested that aggregated statistics about separate accounts be reported on Form ADV. This would include AUM, holdings breakdown by asset type, information about derivatives use, breakdown of AUM by client type, and certain information about the custodians at which the separate account AUM is custodied.

The absence of systematic regulatory data on separate accounts has led to speculation regarding the nature of separate accounts and how they are managed.⁵ We believe that policy and regulation of asset management should be empirically driven; more robust data as contemplated in this rulemaking will further such an effort.⁶

While BlackRock supports the SEC receiving additional data about separate accounts, in our [comment letter](#), we encouraged the SEC to keep the aggregated separate account data confidential and suggested that Form ADV may not be the appropriate form to house this data. Given that separate account assets are owned directly by the client, not

the manager, and managed in accordance with the client's individualized investment guidelines (which are typically developed to comply with the client's own internal risk management policies, regulatory obligations, or other individual constraints), this information could be misleading to the public, as the management of separate account assets could be different from the registered adviser's management of publicly-offered investment products. Separate accounts are not publicly available investment products and, therefore, we believe that they should be given the same treatment as private funds, where data is reported to the SEC on a confidential basis and not to the public.⁷ Further, the purpose of Form ADV has been to collect information on advisers across their business, rather than portfolio-level detail on individual products, making Form ADV an inappropriate mechanism on which to capture information about separate accounts.⁸ In short, we support collecting this data, however, we recommend this information be kept confidential to the regulator as it is not appropriate to be shared with the public.

Investment Company Reporting Modernization

With respect to data reporting for investment products, the SEC proposed [Investment Company Reporting Modernization](#) (Fund Reporting Proposal) on the same day that the Form ADV Proposal was issued. The Fund Reporting Proposal would introduce new reporting requirements for US registered funds through two new forms: Form N-PORT and Form N-CEN. Form N-PORT is a form that funds would be required to complete on a monthly basis to provide information about a variety of aspects of the fund including: detailed information about fund holdings, securities lending activities, use of derivatives, and gross investor flows. As proposed, Form N-PORT filings would be disclosed publicly every third month with a two month lag. The Fund Reporting Proposal would also replace the existing annual form that is completed by US registered funds, called Form N-SAR, with a new annual form, called Form N-CEN. The information on both forms would be sent to the SEC electronically in a structured data format to permit the SEC to perform data analyses using the information provided on Form N-PORT and Form N-CEN. This proposal would also require certain changes to disclosures in fund financial statements. Lastly, the Fund Reporting Proposal also included a provision that would permit funds to deliver shareholder reports electronically as a substitute for physical reports.

As mentioned earlier, BlackRock supports the SEC's efforts to supplement and enhance the data it receives. In our [comment letter](#), we noted that there may be a simpler approach to obtaining the data, particularly where there is overlap with existing forms and data already being provided to the SEC. In particular, we believe that the SEC should leverage its previous work on Form PF by asking US registered funds to respond to relevant questions⁹ on Form PF and only using Form N-PORT for the public disclosure of information that has an obvious benefit to and can be readily

understood by the public.¹⁰ We believe that much of the position-level data requested in Form N-PORT should be kept confidential and disclosed only to the SEC and not be provided in the public domain, as this could lead to detrimental uses of the data. Given that Form PF is a private form reported directly to the SEC, we believe that leveraging the existing infrastructure for Form PF would be a better overall approach. This would facilitate consistency in data collection efforts, which would result in comparable data that could be analyzed across products, increasing the value of the data to SEC. We made several other specific recommendations on the data requested by the SEC, including the comments summarized below:

- ▶ **Investor Flows:** In addition to requesting information about gross investor flows into and out of funds, we believe it would be helpful for the SEC to mandate that aggregated flows by investor types redeeming from and subscribing to funds be accessible to fund managers.¹¹ This additional data would help in the development of redemption models with more predictive capacity than currently exists today given the aforementioned data limitations. This data could be reported to the SEC to help the SEC monitor redemption behavior of different types of investors.
- ▶ **Securities Lending:** In addition to the broader information requests associated with securities lending, BlackRock supports the proposed requirements to increase information about costs incurred by fund shareholders for participating in securities lending programs. Investor protection is well served by a level playing field that allows investors to make informed choices on a risk adjusted basis – balancing expenses alongside performance and risk management capabilities. In order to facilitate investor comparisons, we recommended that the SEC consider requiring reporting the net results to each fund of a securities lending program (i.e., net of cash collateral management fees and other charges) just as funds report fund investment performance net of total expenses.

Further, while some aspects of the SEC’s regulatory reform agenda will increase costs borne by fund shareholders, this rulemaking also included a significant cost savings component in the form of permitting electronic delivery of shareholder reports instead of physical delivery. Tremendous cost savings can be anticipated from electronic delivery of shareholder reports. Under the proposal, all regulatory filings would continue to be produced and available but at a lower cost to the fund, which would in turn benefit fund shareholders. Finally, the reduction in use of paper and related printing and mailing resources that will ultimately result from this change is in line with initiatives to reduce our country’s carbon footprint.¹² Given the global focus on climate change, the “green” element is an important added benefit of this Proposal.

“Exchange-traded products have become an increasingly important investment vehicle to market participants ranging from individuals to large institutional investors”

— Mary Jo White, SEC Chair

Request for Comment on Exchange-Traded Products

On June 17, 2015, the SEC issued a [Request for Comment on Exchange-Traded Products](#) (ETP Request for Comment). The purpose of the ETP Request for Comment was to provide information to the SEC to help inform the SEC’s “review of the listing and trading of new, novel, or complex exchange-traded products (ETPs).”¹³ Today, the SEC regulates most ETPs under the 1940 Act as open-end mutual funds but with fund-specific exemptive orders that, among other things, allow ETFs to create and redeem shares only with certain authorized participants (APs) and permit shares to be traded on an exchange. In other words, there is not a comprehensive “rulebook” designed to specifically regulate ETPs. The ETP Request for Comment asked numerous questions about trading, listing, product structure, and marketing related issues with respect to ETPs. Subsequently, Commissioner Kara Stein gave a speech¹⁴ in which she called for a comprehensive review of ETFs, stating: “we need to take a holistic look at these products, their transparency, and how they interact in our capital markets. This should include not only looking at ETFs, but other exchange traded products that hold commodities, currencies or derivatives.” Commissioner Piwowar similarly has remarked that while the role of ETFs is growing, concerns about certain ETFs may be overblown.¹⁵

Our [comment letter](#) discussed several important aspects of ETPs including: (i) the creation and redemption of shares and the “arbitrage mechanism,” (ii) the role of APs, and (iii) secondary liquidity of ETPs. We specifically encouraged the creation of a classification system to better distinguish different types of ETPs. While all ETPs share certain characteristics, including exchange-tradability, the term “ETF” has become a blanket term describing many products that have a wide range of structures, which has led to a great deal of confusion. Not only are ETFs different from other types of ETPs, but the various types of ETPs also have different structural risks that are masked by the use of a common descriptor. Agreement on a common language would improve investors’ abilities to understand and analyze the risks of individual ETPs.¹⁶ In Exhibit 2, we show the classification system that we suggested the SEC use. A standard classification system would help both policy makers and investors better understand the structure of various ETPs and hone in on where further analysis of issues, and possibly additional regulation, may be warranted.

Exhibit 2: BLACKROCK'S RECOMMENDED CLASSIFICATIONS FOR ETPS

| | | |
|-----|----------------------------|--|
| ETP | Exchange Traded Product | <ul style="list-style-type: none"> • Catch-all term for any portfolio exposure product that trades on an exchange. • ETFs, ETCs, ETNs, and ETIs, are all subsets of ETP. |
| ETF | Exchange Traded Fund | <ul style="list-style-type: none"> • ETFs are publicly-offered investment funds that trade on an exchange. • ETFs can be passive (tracking a specific index) or active (via a transparent basket) that meet diversification and liquidity thresholds set by regulators and exchanges. • ETFs' underlying securities can include stocks, bonds or other investment instruments (e.g., bank loans). • As noted below, this category should exclude funds with embedded leverage or inverse features. |
| ETN | Exchange Traded Note | <ul style="list-style-type: none"> • Debt instruments that provide an index-based return. ETNs may or may not be collateralized, but depend on the issuer's solvency and willingness to buy and sell securities to deliver fully to expectations. • As noted below, this category should exclude notes with embedded leverage, inverse features or options. |
| ETC | Exchange Traded Commodity | <ul style="list-style-type: none"> • A variety of fully-collateralized legal structures that are not ETNs but seek to deliver the unleveraged performance of a commodity, or basket of commodities. • Some ETCs may hold physical commodities, while others invest in commodity futures. • ETCs that invest in commodity futures may raise special issues because futures do not precisely track spot commodity prices. |
| ETI | Exchange Traded Instrument | <ul style="list-style-type: none"> • An ETI is any ETP that has embedded structural features designed to deliver performance that will not track the full unlevered positive return of the underlying index or exposure (that is, products that seek to provide a leveraged or inverse return, a return with caps on upside or downside performance or "knock-out" features). |

For more information on this classification scheme, see BlackRock's [ViewPoint Bond ETFs: Benefits, Challenges, Opportunities](#).

A common theme through all of the submissions we have made to the SEC on its rulemaking agenda is the need for a comprehensive rule that is designed to address the specific issues that may be associated with ETPs and the potential risks associated with different types of ETPs. ETPs are fundamentally different than open-end mutual funds, and therefore require specific rules to address their unique issues. We believe that an ETP rule should start with an ETP classification system as shown in Exhibit 2, and should include rules to address the issues that were described in response to the ETP Request for Comment. As demonstrated by the discussions of the derivatives and liquidity risk management proposals in the following section, continuing to address ETPs in the context of rules designed for open-end mutual funds is neither an effective nor an optimal approach to regulating ETPs.

Open-End Fund Liquidity Risk Management Programs and Swing Pricing

On October 15, 2015, the SEC issued its proposal on [Open-End Fund Liquidity Risk Management and Swing Pricing](#) (LRM Proposal). At the same time, the SEC re-opened the comment period for the Fund Reporting Proposal, as several additional points of data regarding liquidity were added to the new data reporting requirements, highlighting the importance of how this package of rules fits together. The LRM Proposal would apply to US registered open-end mutual funds and ETFs, and would require these funds to articulate policies

and procedures with respect to liquidity risk management. In this context, liquidity risk refers to the ability of funds to meet redemption requests from fund shareholders. Within the context of liquidity risk management programs, the SEC proposed that funds be required to incorporate the following components:

- ▶ **Days-to-Liquidate Bucketing of Fund Holdings:** Each fund would be required to predict the number of days it would take to liquidate – meaning sell and receive cash (settle) – each position in the fund at a price close to the current value. This data would be reported for each fund holding to the SEC on a monthly basis through Form N-PORT. Form N-PORT would then be disclosed to the public every third month with a two month lag.
- ▶ **A "3 Day Liquid Asset Minimum":** Funds would need to determine a minimum percentage of the portfolio that must be held in assets that can be sold and settled in three days at a price close to the current value ("3-day liquid assets"). If a fund were to fall below its minimum, the fund would not be able to buy any securities that are not 3-day liquid assets. The appropriate minimum would need to be determined individually by each fund after reviewing a variety of factors that could impact the need to hold more or less 3-day liquid assets. This minimum (and any changes to the minimum) would need to be approved by the fund's board of directors.

► **15% Illiquid Asset Limit:** The SEC proposed to formally codify existing guidance around the amount of illiquid assets that can be held by open-end funds. Under this rule, funds would be prohibited from holding greater than 15% of the fund's assets in securities that are deemed illiquid, which is defined by the SEC to mean: "any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund." If funds exceed 15% in illiquid assets, they are prohibited from acquiring any additional illiquid assets, though they do not have an obligation to reduce illiquid asset exposure below the 15% threshold. Funds already comply with this element of the proposal through existing guidance. Funds would also need to disclose on Form N-PORT the positions they consider illiquid.

In addition to the liquidity risk management components of the proposal, the SEC proposed to permit open-end mutual funds to use "swing pricing" on an optional basis. Swing pricing is a commonly used fund pricing mechanism in Europe; however, this practice is prohibited under the 1940 Act. Swing pricing essentially allows funds to pass at least some of the transaction costs that the fund must incur to meet redemptions (or to invest proceeds from subscriptions) to the redeeming (subscribing) investors causing those costs to arise. Today, the 1940 Act requires mutual funds to calculate their NAV based on the sum of the net asset values of each fund holding at the end of each day, and all subscription and redemption activity is transacted at that price.

Effective liquidity risk management is essential to properly managing open-end funds, and we have been encouraging regulators to codify best practices in this area for quite some time. As such, we were pleased that the SEC released this proposal and we support the objectives and the "direction of travel" of the LRM proposal. We did, however, cite several concerns regarding the implementation of the proposal and suggested alternative approaches in some instances. In our [comment letter](#), we noted that predicting the time it will take to liquidate a position for cash at a given price in the future is a highly subjective exercise for many types of assets. This creates the possibility that two funds holding the same security could classify the liquidity of that holding differently, which will lead to inconsistent and potentially unusable data being reported to the SEC. As an alternative to the days-to-liquidate buckets, we recommended a more categorical and objective approach based on asset type. Finally, we believe that aggregated information on liquidity categories such as the percentage of a fund held in each category would be more useful information than holding-by-holding reporting, as the aggregated data can be used to compare funds and to identify outliers, whereas holding-level data is more difficult to consume.

Maintaining adequate levels of liquid assets is essential to effectively managing open-end mutual funds. However, requiring a three-day liquid asset minimum will not ensure sufficient levels of liquid assets are maintained and could encourage procyclical behavior. Good risk management dictates that open-end mutual fund managers should be encouraged to meet redemptions by selling securities in order to maintain the fund's risk profile wherever possible. Managers should not be encouraged to meet redemptions primarily by using the most liquid securities held by the fund. Historical data over multiple market cycles demonstrate that open-end mutual fund managers adjust cash balances as a function of the market environment and anticipated redemptions.¹⁷ Further, LRM strategies should not be inconsistent with management of the active risk of a mutual fund, or the volatility of the difference between the return of the fund's assets relative to the return of the fund's prescribed benchmark. Instead, we recommend the SEC require funds to take several steps to ensure a range of liquid assets is maintained.

We agree that a limitation on the amount of illiquid assets that can be held by an open-end mutual fund is appropriate. We also agree that this term should be clearly defined and that the 15% limit on illiquid holdings is reasonable. We suggested that the SEC go further by requiring funds to notify their board of directors and the SEC on a timely basis if the 15% illiquid asset limit is breached for any reason (e.g., if liquid assets are used to meet redemptions and the fund becomes more concentrated in illiquid positions).

We note that many of the key provisions in the LRM proposal assume that all investor redemptions are met by redeeming fund shares for cash. While this assumption correctly applies to open-end mutual funds where investor liquidity is achieved directly from the fund and its portfolio holdings, this mechanism does not accurately describe what happens with almost all ETFs.¹⁸ Unlike open-end mutual funds, ETF investors buy and sell shares on exchanges without directly impacting the actual ETF portfolio's holdings. Imbalances between ETF buyers and sellers impact the exchange price, but do not directly lead to purchases or sales of ETF holdings. As noted earlier, we recommend the SEC develop a separate and comprehensive rule addressing the different types of ETFs and their respective risks rather than trying to include ETFs in a rule designed to address the risks of open-end funds.

Lastly, we support swing pricing as a tool to protect long-term shareholders. BlackRock currently manages many European-domiciled funds whose shareholders benefit from the application of swing pricing. However, because the technology and operational processes that manage mutual fund flows in the US were not developed to support swing pricing, the operational infrastructure required to practically enable swing pricing does not readily exist for the vast

majority of US mutual funds. Depending on the method by which a fund is distributed, there are complexities that will need to be and should be addressed by the SEC. The main challenge lies in obtaining same-day investor net flows prior to publishing the fund's NAV, since the magnitude and direction of net flows determine whether the NAV will be "swung" on a given day and if so, in which direction. In Europe, the dealing cutoff (i.e., the time when investors can subscribe to or redeem from a fund and get the next available NAV) typically occurs several hours before a fund's NAV is published. This gap in time between the dealing cutoff and the NAV determination permits much greater certainty around the direction and level of flows by the time funds are valued. In the US, fund valuation and receipt of fund flows data currently are effectively two separate processes. The current timing of these distinct processes, in most cases, does not permit substantial visibility on fund flows before a fund's NAV is published. In its [comment letter](#) to the SEC, the Global Association of Risk Professionals (GARP) laid out a detailed roadmap of the infrastructure changes necessary to make swing pricing viable in the US.

Use of Derivatives by Registered Investment Companies and Business Development Companies

On December 28, 2015, the SEC issued a proposed rulemaking on the [Use of Derivatives by Registered Investment Companies and Business Development Companies](#) (Derivatives Proposal). The Derivatives Proposal applies to US registered open-end mutual funds, closed-end funds, ETFs, and business development companies. The proposed rule would require funds that use more than a de minimis amount of derivatives to put in place policies and procedures to articulate the fund's derivatives risk management program. This would include designating an individual who is independent from portfolio management to be responsible for derivatives risk management. Today, the SEC effectively limits leverage that can be obtained by US registered funds through borrowing¹⁹ and separately regulates derivatives exposure through asset segregation rules.

- ▶ **Leverage Limits:** The Derivatives Proposal would introduce leverage limits based on gross notional exposure (GNE). Funds would need to comply with one of two limits – either 150% of NAV or 300% of NAV. In order to use the higher limit, funds would need to demonstrate that the use of derivatives is risk reducing for the overall portfolio. This would need to be demonstrated using a value-at-risk (VaR)-based test. The fund would need to show that the VaR of the entire portfolio is less than the VaR of the portfolio when derivatives are excluded.
- ▶ **Asset Segregation:** The Derivatives Proposal is designed to improve the consistency of asset segregation practices, which have traditionally been updated through a series of

guidance and no-action letters. Asset segregation is a requirement that funds hold liquid assets against derivatives exposure. Today, liquid assets are generally considered to be assets that are not "illiquid" under the SEC's definition. Under the Derivatives Proposal, the only assets (called Qualifying Coverage Assets) that would be permitted for asset segregation purposes would be cash and cash equivalents. In addition, the SEC proposed a more consistent approach to calculating derivatives exposure under asset segregation that would entail calculating the mark-to-market value of derivatives positions plus a "risk-based coverage amount" designed to account for potential obligations associated with the derivative position under stressed conditions. Funds would be permitted to offset mark-to-market exposure with any variation margin that was posted for the derivatives transaction, and the risk-based coverage amount could be offset with any initial margin.

In general, we support the objectives of the Derivatives Proposal to set high standards for risk management related to derivatives use and to ensure that the use of leverage is not unlimited or unregulated. Risk management is part of BlackRock's culture and we agree that funds should have effective risk management programs in place to address risks associated with each investment strategy, including those associated with the use of derivatives. We believe that the SEC's existing rules already effectively limit leverage in US registered funds; however, we support the SEC's effort to review and modernize some of its rules. In our [comment letter](#), we made specific recommendations and provided suggestions to improve the proposal, reduce unintended consequences, and help the SEC meet its stated objectives.

In particular, we explained that GNE is not an appropriate measure of leverage or risk, making it inappropriate for use as a leverage limit for US registered funds. Take for example Exhibit 3, which shows several portfolios with the same level of interest rate risk as measured by DV01 – or the expected dollar value of a one basis point change in an instrument's yield. While the portfolios have identical risk, they have GNE ranging from \$17.1 million to \$2 billion, illustrating why GNE is not correlated to or indicative of risk or economic exposure arising from leverage. As an alternative, we suggest defining a more accurate and comprehensive approach to measuring economic leverage. A measure of economic leverage is risk-based and recognizes that derivatives used for hedging do not create leverage. To the extent that the SEC is committed to the approach based on GNE, we recommend several basic adjustments to improve the efficacy of the Commission's proposed portfolio limits in the Derivatives Proposal (although we note that the adjustments will not produce a measure of economic leverage). Specifically, we provided recommendations regarding additional VaR tests that should be permitted to account for additional uses of derivatives by US registered funds.

Exhibit 3: CONTRACTS AND NOTIONAL AMOUNTS REQUIRED TO ATTAIN \$50,000 OF DV01 EQUIVALENT RISK AMONG INTEREST RATE DERIVATIVES

| Contract/Notional Needed to Replicate 50k DV01 Equivalent Risk | | | | |
|--|-----------------------|------------------------|-------------------|---------------|
| Futures | DV01 per Contract | Futures Contract Size* | DV01 per Position | Notional |
| Eurodollar Future | 25 | 2,000 | 50,000 | 2,000,000,000 |
| US 2Y Treasury Note | 43 | 1,163 | 50,000 | 232,600,000 |
| US 5Y Treasury Note | 52 | 962 | 50,000 | 96,200,000 |
| US 10Y Treasury Note | 82 | 610 | 50,000 | 61,000,000 |
| US 10Y Ultra Future | 121 | 413 | 50,000 | 41,300,000 |
| US Long Bond | 228 | 219 | 50,000 | 21,900,000 |
| US Ultra Bond | 293 | 171 | 50,000 | 17,100,000 |
| Swaps | DV01 per 1mm Notional | Swap Notional* | DV01 per Position | Notional |
| 2Y Swap | 173 | 289,000,000 | 50,000 | 289,000,000 |
| 5Y Swap | 461 | 108,500,000 | 50,000 | 108,500,000 |
| 10Y Swap | 905 | 55,200,000 | 50,000 | 55,200,000 |
| 30Y Swap | 2,262 | 22,100,000 | 50,000 | 22,100,000 |

*Swap notionals rounded to the nearest 100,000. Futures rounded to the nearest contract. Contract size and swap notional equal 50,000 divided by DV01 per contract or 1 million notional, respectively. Internal BlackRock duration calculations used.

Funds use derivatives in different ways. The test that permits funds to use the higher leverage limit only considers one use of derivatives and should be expanded to allow funds that use derivatives for other reasons to similarly rely on the 300% leverage limit.

We further noted our concern that limiting Qualifying Coverage Assets to cash and cash equivalents under the revised asset segregation rules could have problematic unintended consequences and potentially conflicts with the objectives of the LRM proposal. We understand that the SEC is concerned about the potential for negative correlations to arise between non-cash fund holdings and potential derivatives liabilities. Many regulators, including the US prudential regulators, have addressed this concern in the context of posting margin for derivatives transactions.²⁰ In particular, these regulations permit a more expanded list of securities to be used as margin so long as an appropriate haircut (i.e., risk-based adjustment) of the value of the security is made. This effectively results in over-collateralization to ensure that even if the value of the segregated or pledged securities falls, there will be sufficient margin to cover the liability. We believe that a similar margin haircutting schedule in addition to including the “risk-based coverage amount” and a daily mark-to-market valuation of assets and derivative obligations will ensure there is sufficient “coverage.” Indeed, the existing asset segregation regime, which does not require haircuts for non-cash assets used for coverage purposes, has been sufficient and to our knowledge has not resulted in any significant issues for US registered funds, including during the 2008 Financial Crisis and other risk events. This regime further avoids imposing additional costs on investors sacrificing returns to invest in non-core assets for collateral purposes.

Stress Testing

While no proposal has been issued as of the publication of this *ViewPoint*, SEC Chair White and other senior SEC staff have indicated that the SEC intends to propose a rule regarding stress testing. We note that there are different forms of stress testing – for example, there is scenario analysis that can be done to determine the impact on portfolio performance of various stress events (i.e., market risk stress tests that involve specifying historical or hypothetical shocks to market risk factors, such as equity prices, credit spreads, rates, etc. and assessing the potential impact on fund performance and risk positioning). There is also a concept of liquidity risk stress testing, which seeks to understand the ability of a fund to meet redemptions under various adverse market and redemption scenarios. While we cannot predict the ultimate contents of any proposal, we anticipate that the SEC will focus on the latter kind of stress testing – liquidity risk stress testing – as this most closely aligns with its recent focus on liquidity risk management. Moreover, the SEC Division of Investment Management issued guidance to fund managers on January 1, 2014 recommending that fund managers regularly assess and test fund liquidity in normal and stressed market conditions.²¹ Given this previous focus on liquidity risk, we believe it is likely that the SEC will incorporate best practices gleaned from monitoring funds’ adherence to this guidance. We again emphasize that this rule should focus only on open-end mutual funds, not ETFs.

We support the SEC’s efforts to develop specific rules regarding the stress testing of mutual funds and if, in fact, the SEC is focused on liquidity risk stress testing, we would encourage the SEC to integrate rules on liquidity risk stress testing with the LRM proposal. While not one and the same,

liquidity risk stress testing represents a useful liquidity risk management tool. However, when considering stress testing of funds, it is important to remember that the concept of liquidity stress testing of funds is quite different from, and should not be conflated with, stress testing of banks or market risk. In particular, mutual funds do not guarantee the value of fund shares or employ significant leverage, requiring different risk management solutions than those applicable to banks. Unlike banks, which have an obligation to meet liabilities (including the repayment of the principal of their depositors), mutual fund redemptions are executed based upon a pro rata share of the value of the securities held in the fund, with no guarantee of a particular price. This means that mutual fund redemptions may result in financial loss to investors if the price of the securities in a fund, sold “pro rata” to meet redemptions, is lower than the price at which securities are held in the fund.

These important differences between bank assets and mutual funds must be considered when applying liquidity stress testing for mutual funds. In short, mutual fund shares are equity claims on the assets of a fund, and shareholders bear the risk of the economic impact of large redemptions.

That said, mutual fund managers must manage fund assets in the best interests of all investors in the fund. This often means maintaining some amount of borrowing capacity to address tail risk redemption scenarios, while at the same time seeking to meet fund redemptions through pro rata selling of fund assets during the majority of circumstances to avoid creating situations where the fund’s assets become materially less liquid as a result of redemptions. Likewise, fund managers should seek to avoid situations where fund assets need to be sold at “fire sale” prices in order to meet redemptions. Ultimately, portfolio managers must use their best judgment to balance the risk of maintaining excessive liquidity against the costs of insufficient liquidity. Liquidity risk stress testing is one tool that can be helpful to ensure fund managers are maintaining appropriate liquidity.

For the liquidity risk stress testing rule to be meaningful and practical, it must be anchored to the current reality of the state-of-the-practice amongst the fund management industry. Therefore, proposed rules need to carefully balance what might be theoretically ideal versus practical reality. Currently, amongst most managers, liquidity risk stress testing is an area of risk management practice that is relatively new; therefore, operational capabilities may be limited. In order to perform stress tests, managers would ideally have the ability to precisely bucket assets (i.e., securities held in funds) into liquidation time frames (i.e., measure the extent to which different types of securities can be converted to cash to meet redemptions). While this can be done readily in the equity markets (where securities trade on exchanges), the OTC nature of fixed income markets and fact that the preponderance of trading occurs in “on-the-run” securities makes it difficult to measure liquidation costs and timing.

Further, from a liability perspective, the ability to access detailed information about the transactional activity of individual fund investors is limited due to contractual limitations and/or operational constraints. In most open-end mutual funds, investor transactions are incorporated into omnibus trades provided to fund managers by fund distributors. Thus, asset managers with funds distributed by third parties do not necessarily have access to transactional history needed to fully study investor redemption behaviors. This means that the analysis of redemption behavior is still in nascent stages of development. In order to properly forecast redemptions, asset managers will need access to historical redemption data at the transaction level and by type of investor.

Even for existing data, the length of available time series to deeply study investor behavior is inconsistent, since some funds may be quite old whereas other funds may be brand new. And, even if long-term time series data were available, the “Black Swan” problem remains, in that the data simply may not contain all of the potential worst-case scenarios.

With these data and redemption modeling limitations as context, we recommend the SEC construct a liquidity risk stress testing rule requiring funds to design a liquidity risk stress testing framework with the following components, recognizing that the quantitative precision of liquidity risk stress test approaches will evolve over time.

1. Ability to quantify potential asset/liability mismatches during normal and stress scenarios:

- **Assets:** Measure or estimate asset values of fund holdings and anticipated transaction costs during normal and stressed market conditions.
- **Liabilities:** Estimate potential fund redemptions based on: (a) historical redemption behavior, (b) redemption behaviors associated with different types of investors, and (c) shareholder concentration. As noted below, this would require greater transparency of reporting to fund managers regarding the underlying investors.
- **Scenario Testing:** Scenario testing should be performed to quantify the potential asset/liability mismatch that could arise due to either (a) stresses to asset values; (b) stressful redemption scenarios (both based on historical redemption rates and hypothetical redemption rates); or (c) simultaneous stresses to both asset values and redemption rates.
- **Monitoring:** Periodic monitoring of the results of scenario testing should be performed by a risk manager to ensure the fund is not becoming materially less liquid over time. Funds should develop tolerances around liquidity stress testing results that are tailored to the liquidity profiles and investment mandates of each fund. Each fund’s liquidity risk management program should specify an individual or group of individuals responsible for monitoring the results of liquidity risk stress testing.

- **Judgment:** At this point in time, fund managers should be allowed to exercise their judgment with respect to how to respond to the results of their liquidity stress tests. Since the “science” of liquidity stress testing for mutual funds is still in its early stages, the SEC should first aim to set these processes in motion and then carefully observe how they progress across the industry. Only at some point in the to-be-determined future (if ever) should the SEC consider mandating specifically defined outcomes or required remediation dependent on these stress test results. While the desire to somehow “fix” a perceived liquidity risk management problem may be great, the lack of complete and consistent data or experience with this type of analysis requires a staged and measured approach. To do otherwise is inadvisable because, at best, such measures would be based on a lack of data and experience.
- **Specified Scenarios:** Subject to the previous paragraph, the SEC may want to create a set of specified scenarios for firms to incorporate into their stress testing regimes. Having a common set of scenarios across fund managers might help the SEC monitor the progress of the industry as it evolves its methodologies over time.

2. “Break-the-glass” testing of backup liquidity measures

Given that it is conceivable that funds may be required to utilize backup sources of liquidity under certain circumstances, funds should be required to demonstrate their ability to operationally access any backup sources of liquidity available to the fund at least annually. In this type of stress test, funds would assume that they are unable to fully meet a redemption by selling fund assets and are required to rely on alternate sources of liquidity. For example, funds would need to test their operational procedures by borrowing a small amount from a committed line of credit for a short period of time. Further, funds should confirm that any required documentation to enable a fund to utilize backup sources of liquidity, such as repurchase agreements, is in place. Given that funds rarely utilize backup sources of liquidity to meet redemptions, it is useful to test the ability to implement backup procedures from time to time.

3. Access to necessary data to facilitate predictive value of stress tests

Accurate liquidity risk stress testing with at least some level of predictive capacity is dependent upon access to data. In particular, redemption rates differ by investor type. For example, 401(k) plan investors tend to have a long time horizon and do not rebalance their assets frequently, if at all.²² The ability to study redemption rates among different types of investors would greatly enhance the industry’s ability to develop predictive models to

understand the potential redemption scenarios to which a fund may be subject. We believe that the success of any liquidity risk stress testing proposal will be based on the ability of fund managers to receive sufficient transparency into omnibus accounts in a consistent and comparable manner across fund distribution platforms. As such, we recommend the SEC either in conjunction with the liquidity risk stress testing proposal or other rulemakings mandate that fund distributors and/or transfer agents provide the following data to fund managers for the purposes of liquidity risk management and liquidity risk stress testing in a consistent format:

- Types of investors redeeming from and subscribing to funds via omnibus accounts;²³
- Size of individual investor holdings to ascertain investor concentration; and
- Length of time each investor has been invested in the fund.

The need for this data is generally recognized in the industry. We note that GARP highlighted that this data should be made available to fund managers in its [comment letter](#) to the SEC regarding the liquidity risk management proposal.

We believe that taken together, the liquidity stress testing measures, as described above, would help funds monitor the potential for adverse redemption scenarios to arise and ensure that they have the ability to implement tail-risk tools to address tail-risk redemption scenarios.

Transition of Client Assets

While no proposal has been issued as of the publication of this *ViewPoint*, the SEC has indicated a forthcoming rule on transition management to ensure that asset management firms have a plan for transitioning the management of client assets, should there be a material disruption to an asset manager’s business.²⁴ Transitioning the management of client assets from one manager to another occurs regularly in the normal course of business. In the case of separate accounts, separate account clients initiate and terminate investment management agreements frequently for a variety of reasons, including changes in the client’s asset allocation, poor performance or client service on the part of the asset manager, and administrative consolidation. Such changes can be implemented on short notice, sometimes in as little as 24 hours, with no noticeable market impact.²⁵ Substituting asset managers can be achieved quickly because client separate account and fund assets are held with custodians who are contractually obligated to the asset owner or fund. Custodians hold the assets regardless of which asset manager the asset owner selects to manage their assets. As such, clients can re-direct the management of an existing portfolio of securities to another manager or can take direct control of the assets themselves. Importantly, assets are not required to physically move nor are assets required to be sold

when there is a change of asset managers; assets remain with the custodian in client-denominated accounts.

With respect to clients invested in funds, in the instance where the manager of a fund goes out of business, fund risk is mitigated due to fund board oversight, which allows boards to implement an expedited asset manager replacement process on an emergency basis. The 1940 Act provides for this very situation by allowing US registered fund boards to replace a manager on a temporary basis without a shareholder vote.²⁶ There are several examples demonstrating that the management of funds is transferred from one asset manager to another without requiring significant asset liquidations or causing any other disruptions to markets. We believe that the processes required to transition the management of client accounts from one manager to another would remain more or less the same during times of market stress, which we would define as significant changes to market risk factors, including downgrades of securities in a particular sector, an unexpected fluctuation in currency valuation, a major shift in asset allocation by a large asset owner, or a natural disaster that disrupts markets in a certain region.

To this end, while it might be sensible for the SEC to require fund managers to have policies and procedures to address key person risk through succession planning, it is unclear what other elements would be included in a rule on transition planning that would be supplemental to existing regulatory requirements.

Guiding Principles

Over the past few years, the discussion on risks in asset management has evolved significantly. Early on, the focus was on applying bank-centric concepts to asset managers;²⁷ however, as asset management was studied more closely, the analyses have shifted to focus on where the risks actually reside – at the product and activity level.²⁸ Importantly, there is a growing understanding that asset managers do not invest their own balance sheets but rather they invest assets on behalf of asset owners. These asset owners choose how to allocate their assets, who should manage their assets, where their assets are custodied, and their preferred investment vehicles. This shift towards products and activities recognizes that industry-wide regulation is the only means of effectively addressing risks in asset management.

Under Chair White's leadership, the SEC has set out and is executing a broad agenda to improve the regulation of the asset management industry. As the primary regulator of asset managers and asset management products, the SEC has the appropriate expertise to review the existing regulatory framework and to target areas for enhanced regulation. We support the SEC's leadership to enhance existing regulations from both an investor protection and systemic risk perspective.

We welcome these initiatives as an important step in modernizing regulation to reflect the myriad of changes in the markets and in investment products and practices over a long period of time. With this in mind, we encourage the SEC to complete its rulemaking agenda by finalizing the rules mentioned above with the following guiding principles in mind:

Take a holistic approach to the package of rules that are in process to ensure consistency and alignment in the collective outcomes.

The series of rules that have already been proposed and the additional rules that are expected to be proposed represent a major overhaul of the existing rules governing asset managers and investment products. It is critical that these rules be considered in their entirety and not as isolated rulemakings, as the interactions between the rules is an important element of their effectiveness. Consistency between rules will be particularly important to avoid confusion and inconsistent implementation.

Endeavor to harmonize data reporting and certain definitions with global standards and existing rules for other investment products and practices.

The European Securities and Markets Authority (ESMA) has created detailed rules around stress testing of funds as well as definitions of leverage. Harmonizing data and definitions provides several benefits. First, consistency enables all market participants, including policy makers, asset managers, and investors, to speak a common language. Second, consistent data can be aggregated, compared, and analyzed across funds. On the other hand, inconsistent data generates fractured information, which is much less useful in monitoring risks or identifying areas for future regulation.

Develop a comprehensive ETF rule focusing on the risks specific to ETFs.

ETFs are fundamentally different from open-end mutual funds and regulation of ETFs should recognize these differences. Unlike open-end mutual funds, ETF investors buy and sell shares on exchanges without directly impacting the actual ETF portfolio's holdings. Imbalances between ETF buyers and sellers impact the exchange price, but do not directly lead to purchases or sales of ETF holdings. The vast majority of ETFs redeem "in-kind," eliminating the need to convert ETF holdings into cash. As a result of these differences, liquidity risk management for ETFs should be very different than for open-end mutual funds. We recommend considering a comprehensive ETF rule, instead of trying to apply rules designed for open-end funds that are not readily applicable to ETFs.

Ensure that the fund board's role of oversight (not day-to-day management) is preserved in all rules.

We agree that fund managers should have a formal and well-defined firm-wide risk governance framework that starts at the

top of the organization with the US registered fund board of directors (or other governing body). We also support a governance process that includes a risk management function independent of portfolio management (for independent oversight of investment, liquidity, counterparty credit, operational, and technology risks) with direct access to the fund board of directors (or other governing bodies of the fund manager). The SEC must ensure, however, that the distinction between oversight and management is not blurred. We encourage the SEC to clarify in all the proposals that the US registered fund board's role is one of oversight, not day-to-day management. This construct has worked well where the SEC has introduced the role of a chief compliance officer (CCO) for US registered funds. The CCO communicates with the fund board regarding compliance matters and all material changes are discussed on at least an annual review basis. The board approves compliance policies and procedures. This approach allows fund boards and responsible adviser personnel to operate in the ways that they work most effectively together.

Calibrate sufficient implementation timeframes for each rule, recognizing the complexity of the new requirements and potential overlapping implementation timelines under the package of new regulations.

Each of the rules that has been proposed requires extensive work for asset managers and funds to achieve compliance. Several rules require written policies and procedures. Other rules require systems changes, programming, and testing to ensure the appropriate controls are in place to comply with new requirements. And still other rules require extensive new reporting. As noted above, these rules need to work well together. Likewise, fund investors would benefit from a comprehensive implementation of new rules rather than a piecemeal approach, especially considering the interrelationships between the rules. It has been suggested that larger fund complexes should get into compliance more quickly than smaller complexes; however, there is no evidence that size is a determining factor in assessing risk, and most larger fund complexes offer numerous different investment strategies, which introduce additional complexity to becoming fully compliant. We recommend a 30 month implementation period for all fund complexes regardless of size.

Looking Forward

The proposed set of SEC rules described above should address perceived data gaps, regulate the use of leverage and derivatives in funds, institutionalize the practice of liquidity risk management including stress testing, and address concerns specific to ETFs. Assuming there is broad agreement that this set of rules addresses risks associated with mutual funds, policy makers have indicated they intend to turn their attention next to "residual" risks to the financial system. We have identified several vulnerabilities that

warrant further attention from policy makers focused on systemic risk:

Central Clearing Counterparties (CCPs)

Prior to the financial crisis, over-the-counter (OTC) derivatives were bilateral agreements between an asset owner and a bank or broker-dealer. Regulators globally have embraced central clearing as an alternative approach that provides much needed transparency and allows policy makers to establish rules governing the use and central clearing of derivatives transactions. However, moving the risk from banks does not eliminate the risk. In particular, while central clearing reduces bi-lateral counterparty risks, CCPs, in essence, centralize the risks and expose the system to the potential failure of a CCP. This is one of the most important systemic risks that still needs to be addressed. The Financial Stability Board (FSB), International Organization of Securities Commissions (IOSCO), Committee on Payments and Market Infrastructures (CPMI), Basel Committee on Banking Supervision (BCBS), Federal Reserve Board (FRB) and Commodity Futures Trading Commission (CFTC) have all acknowledged the importance of making CCPs more resilient as well as establishing guidelines for the resolution and potential recovery of a CCP that experiences difficulties.²⁹

Cybersecurity in market plumbing

Another key area to consider is the infrastructure that underlies the capital markets. This infrastructure includes exchanges, custodians, payment systems, and more. The recent incident in which \$100 million was stolen from the account of the Bank of Bangladesh from the New York Federal Reserve Bank as a result of unauthorized SWIFT messages sent by an unknown source³⁰ highlights the importance of checks and balances in what is expected to be a very secure network. In our [response to FSOC](#), we discussed the importance of this vulnerability. Cybersecurity is just one aspect of market plumbing, but we would prioritize this as one of the most important vulnerabilities that has yet to be fully studied and addressed.

Impacts of low (or negative) interest rates and low oil prices on various asset owners

Critical to understanding the asset management ecosystem is developing a better understanding of the objectives and constraints of various asset owners. Unprecedented monetary policy has kept interest rates extremely low (and, in some cases, negative) for an extended period of time. How does this impact savers, pension funds, insurers? For retirees and savers that are reliant upon their savings to support themselves in retirement, the prolonged nature of an extremely low interest rate environment has challenged their ability to meet their investment objectives by reducing the income their assets generate. Similarly, insurers and other investors have been forced to choose between extremely low yielding bonds and riskier investment strategies. Furthermore, in many cases, monetary policy has involved

asset purchases dramatically growing central bank balance sheets, which has created market distortions. Monetary policy is thus a primary driver of increasing allocations to higher yielding assets such as high yield bonds, emerging markets debt and bank loan assets, because for many asset owners, the risks of not meeting investment objectives (e.g., funding pension liabilities) is greater than the additional investment risks associated with greater allocations to higher yielding asset classes. Likewise, oil prices have dropped dramatically, leading to financial pressures on oil producing economies. Just as asset purchases have changed the profile of central bank balance sheets, the significant drop in oil and commodity prices in 2014 and 2015 has impacted current account surpluses and the asset allocations of sovereign wealth funds, particularly those that are exposed to commodity prices.³¹ Asset owners drive asset allocation decisions, which can have significant impacts on asset prices; the impact of extraordinary monetary policies and low oil prices should be studied to develop a deeper understanding of capital markets behavior before forming any conclusions.

Government pension underfunding

Pension funds represent one of the largest categories of asset owners, and their financial health is important to the overall health of the financial system. Numerous reports have cited the underfunded status of various pension plans, including multi-employer plans, state and municipal plans in the US.³² Similar trends exist in Europe – for example, the defined benefit plan deficit of FTSE companies in the UK has more than doubled in recent years and the funding ratio for German blue chip companies has fallen.³³ Citigroup recently released a reporting finding that the total value of unfunded or underfunded government pension liabilities for twenty OECD countries is \$78 trillion, representing a sizeable asset liability mismatch that should be addressed.³⁴ Low (or in some cases negative) interest rates have exacerbated the challenges facing pension plans. In most cases, underfunding represents a longer-term issue; however, some jurisdictions are facing near-term challenges.

Bond holder rights in resolution and bankruptcy

A series of events since the financial crisis have raised questions about the rights of bond holders in situations involving bankruptcy or resolution of an insolvent entity. In several cases, the rights of bond holders have been unexpectedly subordinated relative to other claims. Financial stability is, in part, dependent on reliable outcomes. Clarifying bond holder rights and understanding that often these bonds are held in mutual funds whose shares are sold to individual investors and in pension funds whose beneficiaries are individuals is important to restoring confidence and avoiding potential fire sales in future situations where the outcome may become uncertain.

Cash pools as they evolve

In the US, the SEC and the Office of Comptroller (OCC) have introduced new rules regarding money market funds regulated by the SEC under Rule 2a-7 and short-term investment funds (STIFs) offered by nationally chartered banks who are regulated by the OCC. However, the largest cash reinvestment pools are associated with custodian banks who are state-chartered and thus are not under the supervision of the OCC. The rules for state-chartered bank STIFs have yet to be addressed. Likewise, MMF reform in Europe has not been completed. Finally, as various new rules come into effect, regulators need to make sure that all associated rules are finalized³⁵ and the impact on markets must be monitored carefully, as these rules may cause unintended distortions that would need to be addressed quickly.

Cumulative impact of reforms

While individual rules generally make sense, sometimes the interaction between rules is not well understood. Over the past few years, an unprecedented number of rules has been introduced. The European Commission's (EC) recent call for evidence on the "EU Regulatory Framework for Financial Services" highlights the importance of taking a holistic view of regulation. As stated by the EC, "it is important that EU legislation strikes the right balance between reducing risk and enabling growth and does not create new barriers that were not intended."³⁶ Given the volume and complexity of new rules, it is important to take a breath and see how all of the rules fit together, and if any changes are warranted.

Notes

1. SEC Chair Mary Jo White, Speech, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014), available at <https://www.sec.gov/News/Speech/Detail/Speech/1370543677722> (SEC Chair White Speech).
2. SEC, Money Market Fund Reform; Amendments to Form PF, 79 Fed. Reg. 47736 (Aug. 14, 2014), available at <https://www.gpo.gov/fdsys/pkg/FR-2014-08-14/pdf/2014-17747.pdf>.
3. SEC, Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80884 (Dec. 28, 2015), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf> (Derivatives Proposal); SEC, Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release Proposed Rule, 80 Fed. Reg. 62274 (Oct. 15, 2015), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-10-15/pdf/2015-24507.pdf> (LRM Proposal); SEC, Investment Company Reporting Modernization Proposed Rule, 80 Fed. Reg. 33590 (Jun. 12, 2015), available at <http://www.gpo.gov/fdsys/pkg/FR-2015-06-12/pdf/2015-12779.pdf> (Fund Reporting Proposal); SEC, Amendments to Form ADV and the Advisers Act, 80 Fed. Reg. 33718 (Jun. 12, 2015), available at <http://www.gpo.gov/fdsys/pkg/FR-2015-06-12/pdf/2015-12778.pdf> (Form ADV Proposal); SEC, Request for Comment on Exchange Traded Products, 80 Fed. Reg. 34729 (Jun. 17, 2015), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-06-17/pdf/2015-14890.pdf> (ETP Request for Comment).
4. Form ADV Proposal.
5. See e.g. Office of Financial Research, 2014 Annual Report (2014), available at <http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2014.pdf>. Financial Stability Oversight Council, 2015 Annual Report (2015), available at <http://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/2015%20FSOC%20Annual%20Report.pdf>.
6. For example, industry efforts such as the Asset Management Group of the Securities Industry and Financial Markets Association (“SIFMA AMG”) study that gathered aggregated separate account data voluntarily from nine asset managers representing over \$3.98 trillion in SMA AUM was a helpful first step in obtaining empirical data on separate accounts. The study results showed that 99% of this AUM was long-only, with 53% invested in passively managed, diversified index strategies. Contrary to the previous speculation of certain policy makers, in aggregate, less than 4% of the number of surveyed separate accounts employed leverage and the average leverage reported for these accounts was modest. Likewise, less than 2% of the separate accounts surveyed held illiquid securities. See SIFMA, Comment Letter, Response to the FSB’s Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions and the OFR’s Asset Management and Financial Stability (Apr. 4, 2014), available at <http://www.sifma.org/issues/item.aspx?id=8589948419>.
7. See e.g., SEC, Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71155-71156 (Nov. 16, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-11-16/pdf/2011-28549.pdf>.
8. While Form ADV gathers information on the amount of assets and a general description of private funds advised by the adviser, the portfolio level detail on private funds is provided confidentially to the Commission on Form PF and not disclosed publicly.
9. In general, we believe the following Questions on Form PF would be relevant to mutual funds: 8, 9, 12, 13, 17, 24, 28, 30, 32, 33, 34, 35, 42, and 44. See Form PF, 76 Fed. Reg. 71128 (Nov. 16, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-11-16/pdf/2011-28549.pdf>.
10. In particular, we note that data on flows, performance, and fees would be helpful in the public domain.
11. In connection with the adoption of 1940 Act Rule 22c-2, RICs found that obtaining information on underlying shareholders in omnibus accounts is difficult in the absence of an express requirement that financial intermediaries supply the relevant information. We suggest that the Commission consider this experience in crafting any request for detailed omnibus account data. See SEC, Mutual Fund Redemption Fees Final Rule, 70 Fed. Reg. 13337 (Mar. 18, 2005), available at <https://www.gpo.gov/fdsys/pkg/FR-2005-03-18/pdf/05-5318.pdf> (“Rule 22c-2 also is designed to enable funds to monitor the frequency of short-term trading in omnibus accounts and to take steps, where appropriate, to respond to this trading. We believe that this requirement will facilitate greater cooperation between funds and their intermediaries. The right to access this trading information provides funds with an important new tool to monitor trading activity in order to detect market timing and to assure consistent enforcement of their market timing policies.”).
12. See e.g., Office of the Press Secretary, Fact Sheet: White House Launches American Business Act on Climate Pledge (Jul. 27, 2015), available at <https://www.whitehouse.gov/the-press-office/2015/07/27/fact-sheet-white-house-launches-american-business-act-climate-pledge>.
13. SEC, Press Release, SEC Publishes Request for Public Comment on Exchange-Traded Products (Jun. 12, 2015), available at <https://www.sec.gov/news/pressrelease/2015-118.html>.
14. SEC Commissioner Kara M. Stein, Speech, Remarks at the “SEC Speaks” Conference: What Lies Ahead? The SEC in 2016 (Feb. 19, 2016), available at <https://www.sec.gov/news/speech/stein-sec-speaks-2016.html>.
15. SEC Commissioner Michael S. Piwowar, Remarks at the 2015 Mutual Funds and Investment Management Conference (Mar. 16, 2015), available at <https://www.sec.gov/news/speech/031615-spch-cmsp.html>.
16. It is frequently difficult for investors to compare even structurally similar ETPs. For example, various market data services, electronic trading systems, broker-dealers and sponsors of fixed-income ETFs have historically each reported basic metrics such as yield, spread and duration using their own proprietary calculations. This has made it difficult to compare fixed income ETFs to other fixed-income investments, as well as to each other. A number of leading market participants have recently come together to promote a common reporting standard. See Alastair Marsh, BlackRock, State Street Seeking ETF Standards for Trading Boost, Bloomberg (Jul. 27, 2015), available at <http://www.bloomberg.com/news/articles/2015-07-27/blackrock-state-street-seeking-etf-standards-for-trading-boost>.
17. BlackRock, *ViewPoint*, Who Owns the Assets? A Closer Look at Bank Loans, High Yield Bonds and Emerging Markets Debt (Sep. 2014), available at <http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf>.
18. For the subset of ETFs that meet redemptions in cash, the LRM Proposal does have some applicability; however, they can be better addressed in a broader ETF rule.
19. US registered funds are subject to the 1940 Act rules regarding limits on borrowing and on collateralizing derivative exposures. Borrowings are limited to 33.3% of total fund assets (i.e., the fund must have asset coverage of 300%), which equates to a total asset limit of 1.5 times net assets. US registered closed-end funds may also issue a single class of preferred stock (subject to a 200% asset coverage requirement). 15 U.S.C. § 80a-18(a)(1)(B). In addition, although the Internal Revenue Code does not contain explicit limitations on leverage, borrowing may impact the tax character of distributions paid to shareholders and interest expense may not be deductible for tax purposes in certain circumstances. In addition, income received from certain derivatives contracts may not constitute qualifying income for purposes of the gross income test applicable to regulated investment companies. Together, the provisions further limit the ability of 1940 Act Funds to utilize leverage.

Notes

20. Department of the Treasury, Federal Reserve System, Federal Deposit Insurance Corporation, Farm Credit Administration and Federal Housing Finance Agency, Margin and Capital Requirements for Covered Swap Entities, 80 Fed. Reg. 74840 (Nov. 30, 2015), available at <https://www.gpo.gov/fdsys/pkg/FR-2015-11-30/pdf/2015-28671.pdf> (Swap Margin Rule); Commodity Futures Trading Commission, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016), available at <https://www.gpo.gov/fdsys/pkg/FR-2016-01-06/pdf/2015-32320.pdf> (CFTC Margin Rule).
21. SEC Investment Management Guidance Update No. 2014-01, Risk Management in Changing Fixed Income Market Conditions, (Jan. 2014), available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf>.
22. For example, ICI conducted a study of DC plans and found that between 2009 and 2015, only 6.4% to 7.7% of individuals participating in DC plans changed their asset allocations. See ICI, Research Report: Defined Contribution Plan Participants' Activities, First Half 2015 (Nov. 2015), available at https://www.ici.org/pdf/ppr_15_rec_survey_q2.pdf. A real-world example of this phenomenon can be observed in light of recent equity market performance. Despite the poor performance of the S&P 500 in early 2016, retirement savers do not appear to be fleeing from equities or otherwise exhibiting large-scale correlated investment behavior. See Sarah Skidmore Sell, Miami Herald, Panic is passé: investors stay steady on retirement savings (Jan. 27, 2016), available at <http://www.miamiherald.com/news/business/article56827658.html>.
23. We note that transparency to individual client-level information would not be useful or needed to implement this recommendation. In particular, the investor categories that would be helpful are (i) 401K plan / Individual Retirement Account; (ii) pension fund; (iii) insurance company; (iv) other institutional investor (e.g., sovereign wealth fund); and (v) retail investor. See Fund Reporting Response.
24. SEC Chair White Speech; SEC Director of Investment Management David Grim, Speech, Remarks to the Investment Company Institute's 2016 Mutual Funds and Investment Management Conference (Mar. 14, 2016), available at <https://www.sec.gov/news/speech/david-grim-remarks-to-ici-2016-mutual-funds-and-invest-mgmt-conf.html>.
25. We believe that the transition of separate accounts from one manager to another is typically no more difficult or impactful than transitions of other types of accounts or pooled vehicles. In some cases, asset sales may be directed by the client, but based on our experience, this would apply to a very limited amount of separate account assets. Therefore, these transitions would not contribute to systemic risk. See BlackRock, Comment Letter, Addendum to Feedback on OFR Study on Asset Management and Financial Stability – SEC (Dec. 3, 2013), available at <http://www.blackrock.com/corporate/en-us/literature/publication/ofr-study-addendum-sec-120313.pdf>.
26. 15 U.S.C. § 80a-15. 1940 Act Rule 15a-4 provides that, subject to certain conditions, a fund board can appoint a new investment adviser to a fund for a period of up to 150 days without first obtaining shareholder approval of the new advisory contract. The Rule permits fund boards to appoint a new adviser in an emergency situation where the original adviser's contract has been terminated.
27. FSB and IOSCO, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Jan. 8, 2014), available at http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf; FSB and IOSCO, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Mar. 4, 2015), available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD479.pdf>.
28. FSOC, Minutes of the Financial Stability Oversight Council (Jul. 31, 2014), available at <https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031,%202014.pdf>; IOSCO, Press Release, Meeting the Challenges of a New Financial World (Jun. 17, 2015), available at <https://www.iosco.org/news/pdf/IOSCONEWS384.pdf>; FSB, Press Release, Next Steps on the Assessment Methodologies for Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Jul. 30, 2015), available at <http://www.fsb.org/wp-content/uploads/NBNI-G-SIFI-Next-Steps-Press-Release.pdf>.
29. See e.g., FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions (Oct. 15, 2014), available at http://www.fsb.org/wp-content/uploads/r_141015.pdf; CPMI and IOSCO, Recovery of Financial Market Infrastructures (Oct. 2014), available at <http://www.bis.org/cpmi/publ/d121.pdf>; CFTC, Derivatives Clearing Organizations and International Standards (Nov. 15, 2013), available at <http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/federalregister111513.pdf>.
30. Arun Devnath, Bloomberg, Printer Error Triggered Bangladesh Race to Halt Cyber Heist (Mar. 16, 2016), available at <http://www.bloomberg.com/news/articles/2016-03-16/printer-error-set-off-bangladesh-race-to-halt-illicit-transfers>.
31. Institute of International Finance, Capital Flows to Emerging Markets (Jan. 19, 2016); Invesco, Global Sovereign Asset Management Study (2015).
32. Citigroup, The Coming Pensions Crisis: Recommendations for Keeping the Global Pensions System Afloat (Mar. 2016), available at <https://ir.citi.com/CqVpQhBifberuzZKpfhSN25DVSesdUwJwM61ZTqQKceXp0o%2F0F4CbFnnAY11rRjW> (Citi Pensions Report); Moody's Investor Service, Market Volatility Points to Growing US Public Pension Debt in 2016 (Mar. 17, 2016); Meaghan Kilroy, Pensions & Investments, Moody's: Low returns skyrocketing public pension fund liabilities (Mar. 17, 2016), available at http://www.pionline.com/article/20160317/ONLINE/160319881/moody8217s-low-returns-skyrocketing-public-pension-fund-liabilities?newsletter=plan-sponsor-digest&issue=20160317&utm_source=Newsletters&utm_medium=email&utm_campaign=P%26I%20Plan%20Sponsor%20Digest.
33. Citi Pensions Report; Mags Anderson, Low Interest Rates Double FTSE 350 DB Pension Scheme Deficits from £56bn to £107bn Over 2014, Mercer (Jan. 6, 2015), available at http://www.mercer.com/content/mercer/global/all/en/newsroom/low_interest_rates_double_ftse350_db_pension_scheme_deficits.html; Chris Brian, European Companies Dig Deeper to Fill Pension Holes, Financial Times (Feb. 8, 2015) available at <http://www.ft.com/cms/s/0/40158032-ab84-11e4-b05a-00144feab7de.html>.
34. Citi Pensions Report.
35. See e.g., I.R.S., Internal Revenue Bulletin 2014-33, 370 (Aug. 11, 2014) available at <https://www.irs.gov/pub/irs-irbs/irb14-33.pdf>.
36. EC, "Call for Evidence: EU Regulatory Framework for Financial Services" (Sep. 30, 2015), available at http://europa.eu/rapid/press-release_MEMO-15-5735_en.htm.

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