MEMORANDUM

June 9, 2017

TO: File No. S7-13-16
File No. S7-24-15
File No. S7-08-15

FROM: Mark T. Uyeda
Office of Chairman Jay Clayton

RE: Meeting with the Investment Company Institute

On June 8, 2017, Chairman Jay Clayton, along with Lucas Moskowitz, chief of staff, Sean Memon, deputy chief of staff, Jaime Klima, chief counsel, John Cook, senior advisor, and Mark Uyeda, senior advisor, met with representatives of the Investment Company Institute (ICI). The ICI representatives were Paul Schott Stevens, president and CEO, Brian Reid, chief economist, Marty Burns, chief industry operations officer, and Dorothy Donohue, deputy general counsel.

The participants discussed a number of issues affecting registered investment companies, including proposed Commission rules on use of derivatives, business continuity and transition plans, and electronic delivery of fund disclosures. The ICI provided the attached submissions on derivatives and business continuity plans.

Propose a New Appropriately Tailored Rule to Address Funds' Use of Derivatives

Background:

The Commission proposed a rule in 2015 designed to ensure that funds do not hold unduly speculative portfolios and have sufficient assets to meet their payment obligations. The proposal would require a fund to (i) comply with one of two alternative portfolio limits designed to restrict its leverage obtained through derivatives, (ii) segregate an amount of qualifying coverage assets (namely limited to cash and cash equivalents) for certain derivatives and other types of transactions, and (iii) establish a formalized derivatives risk management program.

We support the Commission's goal of modernizing regulations in this area and believe several key elements of the proposal, including the derivatives risk management program and aspects of the proposed asset segregation requirements, would further that objective. We oppose certain other aspects of the proposal—portfolio limits and limiting qualifying coverage assets to cash and cash equivalents. Portfolio limits could restrict funds from using derivatives, even for hedging or other risk mitigation purposes. Imposing the portfolio limits in the current proposed rule would cause at least 369 funds with $458 billion in assets under management to de-register or substantially change their investment strategies to continue their businesses as registered funds under the SEC's proposal. This result would reduce the investment choices American investors have to meet their long-term financial goals. Limiting qualifying coverage assets to cash and cash equivalents also would force funds to liquidate securities and hold more cash than they otherwise would, potentially reducing returns and resulting in portfolio inefficiencies.

ICI's Recommendation:

We urge the SEC to issue a new proposed rule that would require a sensible formalized derivatives risk management program and an appropriate asset segregation regime, including an expanded category of assets eligible for segregation. The SEC also should not include portfolio limits in any new proposal. This approach would rationalize asset segregation requirements set forth in existing informal guidance and provide clarity to the industry in this area for the first time in over 35 years. This kind of rule would encourage funds to invest in the derivatives markets confidently and responsibly. We expect to submit a recommendation to the SEC in the coming months that will include a proposed regime for an asset segregation.

Additional ICI Materials:

ICI submitted or published the following materials in response to the SEC's 2015 proposal:

- Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated March 28, 2016, available at www.sec.gov/comments/s7-24-15/s72415-114.pdf

- ICI Viewpoints, "Derivatives—Please Don't Let Them be Misunderstood," Shelly Antoniewicz, February 22, 2016, available at www.ici.org/viewpoints/view_16_derivatives_imf

Suspend Development of Stress Testing Proposal and Consider Whether to Move Forward With Business Continuity and Transition Planning Proposals

Background:

Section 165(i) of the Dodd-Frank Act requires the SEC to adopt rules requiring large funds and investment advisers (*i.e.*, those with total consolidated assets greater than $10 billion) to conduct annual stress testing. A stress testing regime focusing on capital sufficiency may make sense for banks, but not for funds (whose losses and gains are borne by shareholders *pro rata*) or advisers (which provide advice to their clients on an agency basis, but do not "own" the client assets that they manage).

Dodd-Frank's stress testing provision essentially would have the Commission create a square peg (a stress testing regime for funds and advisers) to fit a round hole (stress testing that evaluates whether financial companies have sufficient capital "necessary to absorb losses as a result of adverse economic conditions"). Mark Flannery, the Commission's former Chief Economist and Director of the Division of Economic and Risk Analysis, raised serious concerns with the Dodd-Frank stress testing provision. Despite these concerns, we understand staff has been working on developing a proposal for the Commission to consider. A bill introduced in the House of Representatives last year that is presently being considered for amendment and reintroduction in this Congress recognizes the overbroad nature of the stress testing mandate, and would remove large funds and advisers from its ambit.

This pending legislation seems sensible, particularly because the SEC's new liquidity rule (which applies to all long-term open-end funds) incorporates elements common to liquidity stress testing (*e.g.*, a fund's assessment, management, and review of its liquidity risk must include consideration of its (i) investment strategy and liquidity of portfolio investments during both normal and reasonably foreseeable stressed conditions, and (ii) short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions).

The SEC proposed a business continuity and transition planning antifraud rule for investment advisers in 2016. The SEC first articulated the need for advisers to have business continuity plans in a 2003 rulemaking on compliance programs. Since then, the SEC staff has examined fund complexes and their critical service providers' business continuity plans and capabilities following disruptive events (*e.g.*, Hurricanes Sandy and Katrina) and has published its findings. This approach—a general expectation set forth by the Commission, supplemented with periodic and topical SEC staff guidance—has worked well in the area of business continuity planning. This approach is warranted especially because of the evolving nature of this area.

Advisers have extensive experience with transitions and the planning they require, but typically do not have any formal, explicit regulatory requirement to have a transition plan. In our view, an overall assessment of the asset management industry's experience with transitions does not demonstrate a compelling purpose or need for regulatory requirements in connection with transition planning.

ICI's Recommendation: We respectfully urge you to direct the Division of Investment Management to suspend, pending further Congressional action or clarification, development of a stress testing proposal for large funds and advisers.

If the SEC continues to believe a business continuity and transition planning rulemaking on investor protection grounds is necessary, it should (i) disavow the proposing release's intimation that that business continuity- or transition planning-related violations (as determined by the SEC) would constitute *per se* fraud or deceit; (ii) keep all rule elements flexible and principles-based; and (iii) make abundantly clear that any transition planning requirements are limited in scope, general in applicability, and in no way analogous to the Dodd-Frank Act's resolution plan or "living will" requirements applicable to certain bank holding companies and other financial companies.

Additional ICI Materials: ICI submitted a comment letter in response to the SEC's 2016 proposal on business continuity and transition planning:

- Letter from David W. Blass, General Counsel, ICI, to Brent J. Fields, Secretary, SEC, dated August 23, 2016, available at www.sec.gov/comments/s7-13-16/s71316-6.pdf