



June 5, 2015

*Via Email*

Ms. Diane Blizzard  
Associate Director, Rulemaking, Division of Investment Management  
U.S. Securities and Exchange Commission  
100 F Street, N.E.  
Washington, D.C. 20549

**Re: Asset Management Fund Stress Testing Rulemaking**

Dear Ms. Blizzard:

Thank you for meeting with the Asset Management Group of the Securities Industry and Financial Markets Association (“the AMG”) in February regarding the Securities and Exchange Commission’s (“SEC”) efforts to develop a fund stress testing rulemaking. The AMG recognizes that the SEC has the responsibility to draft such a rulemaking in accordance with Section 165(i)(2)(A) of the Dodd-Frank Act.<sup>1</sup>

As discussed in that meeting, the AMG believes that any rulemaking should be principles-based, given the unique characteristics of funds and the asset management industry generally. The SEC should also recognize that stress testing is only one part of an effective and coherent risk management process for asset managers. Therefore, the objective of the stress testing is not to test for solvency or capital adequacy, but to complement other approaches in assessing investment risk.

We appreciate the SEC’s efforts and believe that risk management practices are essential, because they make the markets safer for all investors. In an effort to assist the SEC in its efforts and as requested in the meeting, we are attaching a document outlining principles that we believe should be a part of any fund stress testing rulemaking. The AMG would welcome the opportunity to talk though this document with you and your staff at your convenience. Please feel free to contact Tim Cameron at (202) 962-7447 or Lindsey Keljo at (202) 962-7312.

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<sup>1</sup> Section 165(i)(2)(A) of the Dodd-Frank Act states, “A nonbank financial company supervised by the Board of Governors and a bank holding company described in subsection (a) shall conduct semi-annual stress tests. All other financial companies that have total consolidated assets of more than \$10,000,000,000 and are regulated by a primary Federal financial regulatory agency shall conduct annual stress tests.”

Sincerely,

A handwritten signature in black ink, appearing to be 'T. Cameron', with a long horizontal flourish extending to the right.

Timothy W. Cameron, Esq.  
Asset Management Group – Head  
Securities Industry and Financial Markets Association

cc: Hon. Mary Jo White, Chair  
Hon. Daniel M. Gallagher, Commissioner  
Hon. Kara M. Stein, Commissioner  
Hon. Michael S. Piwowar, Commissioner  
Hon. Luis A. Aguilar, Commissioner  
Mr. David Grim, Director, Division of Investment Management  
Mr. Thoreau Bartmann, Branch Chief, Office of Regulator Policy, Division of Investment Management

## ASSET MANAGEMENT STRESS TESTING

**PRINCIPLES BASED: Any regulatory framework for asset management stress testing should be principles-based, rather than prescriptive.**

### WHY PRINCIPLES-BASED?

**Stress Testing Goals:** Asset managers seek to identify from the array of detectable risks the material risks to which their funds and other accounts may be exposed -- and seek to choose the appropriate metrics to monitor those risks and may choose to set appropriate limits and/or thresholds. Stress testing is one part of an effective and coherent risk management process for asset managers; the objective of which is not to test for solvency or capital adequacy but to complement other approaches in assessing investment risk.

- Stress testing is a valuable adjunct to the risk measurement process but cannot exist in a vacuum. It is one part of the overall process.
  - Stress material risk factors to determine potential vulnerabilities given fund risk factor exposures relative to the benchmark.
  - Reverse stress tests to target the portfolio's most significant risks.
  - Stress extraneous factors to uncover unintended risks or to identify factors initially deemed as immaterial (i.e. emerging risks).
- Stress testing helps inform – though does not direct – the investment managers' decision making process, which involves making the appropriate risk/return trade-offs on behalf of clients while complying with the client's stated investment objective and guidelines.
- In order to evaluate the materiality of a given risk, asset managers need objective criteria – stress testing can play a role in creating these criteria.

**Complexity:** Risk management is as much an art as a science.

- Stress testing is a fluid and dynamic process that is ever changing.
  - Expectation/views could change based on the information set available. For example, Greece leaving the Euro would be viewed differently at different times, and would cause different results depending on other factors.
  - Asset managers are heterogeneous and the funds and other accounts that they manage are heterogeneous. Since asset managers are diverse, they will view world events and their potential outcomes differently from one another, and will focus on the issues of relevance to the portfolio's strategies.

- The depth and complexity of the risk management process should match the complexity and sophistication of the investment management process to which it applies.
  - The essence of risk is uncertainty about the future. If the future were known, then all our decisions would be fully informed, all outcomes determined and there would be no risk.
  - Quantitative analysis of the past can provide significant insights into the behavior of assets under certain foreseeable circumstances; however history never repeats itself exactly. An element of judgment must therefore enter into risk measurement and particularly into stress testing.
  - Hypothetical stress testing is even more reliant upon the judgment of the asset/risk manager.

**Multi-Dimensional Metrics:** Risk and the related metrics that measure risk are multi-dimensional and often non-linear in nature (they may behave differently for small and large moves and up versus down moves). It may be appropriate to look at one or more metrics, depending on the fund or account. A representative but not exhaustive list of potential risks are included below.

- Market Risks (e.g. price, interest rate, spread, volatility, currency exposure, equity risk, etc.)
- Credit Risk (e.g. issuer, counter-party, etc.)
- Liquidity Risk (e.g. liquidity of holdings, anticipated flows, etc.)

#### **THE PITFALLS OF A PRESCRIPTIVE APPROACH**

- A prescriptive approach is unlikely to encompass the complexity and breadth of the risk management process; it would be nearly impossible to define a prescriptive framework that would fit all asset classes, all market conditions and all approaches to asset management.
- Prescriptive approaches would be dangerous because they could force asset managers to measure the wrong variables some or all of the time, in part because prescriptive approaches are not dynamic and do not change over time.
- To the extent that a prescriptive approach failed to adequately define the risk metrics and stress tests appropriate to a given fund's risk profile, it could be either useless or harmful.
- A prescriptive approach would create perverse incentives to meet the requirements, but not engage in truly appropriate risk management and stress testing. It would incent a "check the box" mentality rather than a principles-based approach regarding risk management and stress testing.
- A prescriptive approach will tend to make stress testing an operational burden to be met whereas a principles-based approach incents firms to make risk management and stress testing part of the investment management DNA of the firm.
- Prescriptive obligations if significant will have a disparate adverse impact on smaller firms, which may have varied management styles.
- Prescriptive obligations therefore suppress innovation and flexibility in firms' approaches to risk management. Risk management, like risk itself, is dynamic and ever changing. Models will lose effectiveness as market risk and product regimes evolve.

## ELEMENTS OF A PRINCIPLES-BASED APPROACH

**Appropriate Scope:** The risk management process should be appropriate to the scope, complexity and sophistication of the investment management process and tailored to the particular product, portfolio, and current market conditions.

- Stress tests should be designed to cover exposures that the risk and investment teams consider most significant for a particular product.
- Stress tests should be designed to adapt to current markets and risk regimes.
- Stress tests should incorporate meaningful potential “shocks” to a portfolio. It may make sense in certain situations, at the asset managers’ discretion, to combine various events or factors in one scenario to reach an appropriate shock.
- Simpler risk measurement techniques, such as exposure/sensitivities (including duration), beta, value at risk and ex ante tracking error, are used for the majority of risk assessment. Stress tests’ unique role, compared to other risk measures, is to simulate behaviors that differ from current or “normal” market conditions – for instance by stressing:
  - Correlation assumptions and co-movement of portfolio elements
  - Sizes of market movements
  - Liquidity assumptions
  - Impact of explicit and imbedded optionality in security pay-offs

**Risk Decomposition:** The risk management process begins with effective risk decomposition identifying those factors that underlie the various material risks to which funds and other accounts are exposed. This allows asset managers to apply stress tests either directly through appropriate instrument valuation models, or otherwise through exposure measures that have been created by relevant models. In line with the dynamic and evolving nature of risk, risk decomposition includes ensuring that asset managers keep current with risk modeling practices.

**Material Risks:** Asset managers should identify the material risks to which their funds and other accounts are subject, and periodically review and update the risk inventory to address changing market conditions, world events, and other factors.

- Risks should be outlined in disclosures in a fund's publicly available documents, offering memoranda, or Investment Management Agreements.
- Through risk profiles, asset managers communicate to senior management the basic elements and parameters of the risk management process.

**Risk Metrics:** Risk metrics, consistent with the investment themes of each fund, are identified and monitored.

- Asset managers identify the risk characteristics associated with the investment themes which for public funds may be outlined in public documents. Stress testing is used to help ensure that the risk characteristics are consistent with the investment themes of the portfolio under a variety of situations.

- Stress testing should form a part of the risk management process in terms of trying to anticipate the impact of identified potential events on the funds and other accounts managed by the asset manager.

**Types of Stress Tests:** There are multiple methodological approaches to stress tests. Model selection should fit the risks of the portfolio or risk factor being stress tested. The specification should include all relevant terms and conditions of the underlying portfolio/instrument.

- **Historical Stress Tests:** Historical stress tests can inform as to the impact of past crises on current holdings.
- **Hypothetical Stress Tests:** Hypothetical stress tests can provide insight into the impact of scenarios the asset manager considers potential threats.
- **Reverse Stress Tests:** Reverse stress testing can be used to target the current exposures in the portfolio, and reveal the level of change in one or many risk factors that can pose significant risks or cause change in the value of a portfolio.

**Benchmark-Relative Stresses v. Absolute Stresses:**

- Stresses relevant to client expectations (e.g. benchmarks chosen as asset allocation decisions) are relevant in stress testing analysis.
- In the majority of asset management applications, only benchmark relative stresses are relevant because the client has made the asset allocation decision and the fund risks are disclosed.
- There are certain mandates (e.g. absolute return) where absolute stress tests may be appropriate.

**Conflicts of Interest:** Due consideration should be given to the mitigation of any potential conflicts of interest.

- The actual locus of the risk management and stress testing function is less important than transparency to those that are managing the portfolio on a daily basis and to senior management on a periodic or more frequent basis, as necessary.
- Firms have different approaches to where stress testing resides within the firm; there is no one “right” place to put the function, as long as appropriate policies and procedures exist to minimize potential conflicts of interest.
- Risk metrics and stress test results should be reported to senior management on a regular basis and as needed.

**Management Mitigation Actions:** The stress test should not assume hypothetical mitigation efforts, such as hedging an emerging risk, as the purpose of a stress test is to see what would happen if no actions could be taken to mitigate the stress.

**Re-Running Stress Tests:**

- It is helpful to run the same stresses periodically through time as changes in exposure to a stress may occur.
- Stresses should be reviewed and updated periodically to cover important emerging aspects of portfolio composition, and continue to be a good match to the portfolio's material risks.