Morgan Lewis

ASSET MANAGERS: A NEW ERA OF REGULATION?

Jack O'Brien
Michael Philipp
Joshua Sterling

December 14, 2017

Overview

- Changes in Washington
- Treasury Report
- What to Expect in 2018

CHANGES IN WASHINGTON

SEC Roster – Commissioners

- Chair Jay Clayton
  - Independent
  - Sworn in on Thursday, May 4, 2017
- Michael Piwowar
  - Republican
  - Was Acting Chair prior to Chair Clayton’s arrival
  - Economist background
  - Term expires 2018
- Kara Stein
  - Democrat
  - Remains after term expired 2017
- Nominees (one per party)
  - Robert Jackson (Democrat)
  - Hester Peirce (Republican)
  - Unanimously approved by Banking Committee on November 1, 2017

SEC Roster – Staff

- Division of Investment Management
  - Dalia Blass named Director in August 2017
  - Doug Scheidt remains Associate Director and Chief Counsel

- Division of Trading & Markets
  - Brett Redfearn named Director in October 2017

- Division of Corporation Finance
  - William Hinman named Director in May 2017

SEC Roster – Staff

- Division of Enforcement
  - Stephanie Avakian and Steve Peikin named Co-Directors in June 2017
- Division of Economic and Risk Analysis
  - Jeffrey Harris named Director in August 2017
- Office of Compliance Inspections and Examinations
  - Peter Driscoll named as Director in October 2017

CFTC Roster – Commissioners

- Commission consists of 5 Commissioners, but only 3 currently have been confirmed
- Chair - Christopher Giancarlo (R)
  - Sworn in June 16, 2014, confirmed as Chair August 3, 2017
  - Previously, was EVP for an inter-dealer broker
  - Agenda: Reduce regulatory burdens; improve market intelligence; embrace FinTech; improve market liquidity; fix flawed swaps rules; promote better international cooperation; normalize CFTC operations; focus on core missions; improve operations
- Commissioner Brian Quintez (R)
  - Sworn in August 15, 2017
  - Previously, was Managing Principal and Chief Investment Officer of a registered CPO, and has worked as an analyst at an RIA
- Commissioner Rostin Benham (D)
  - Sworn in September 6, 2017
  - Previously, served as senior counsel to US Senator Debbie Stabenow of Michigan, Ranking Member of the Agriculture, Nutrition, and Forestry Committee

CFTC Roster – Commissioners

- Nominees Pending
  - Dawn Stump (Government relations professional) (R)
  - To be named later? (D)
- CFTC Advisory Committees (Agriculture; Energy and Environmental; Global Markets; Market Risk; Technology)—Created to provide input and make recommendations to the CFTC

CFTC Roster – Staff

- **Division of Swap Dealer and Intermediary Oversight (DSIO)**
  - Matthew B. Kulkin (Sept. 20, 2017)
  - Previously in private practice specializing in DFA implementation
- **Division of Market Oversight (DMO)**
  - Director, Amir Zaidi (Jan. 27, 2017)
  - With the Commission since 2010 and has served in various roles for Commissioners and in DMO
- **Division of Clearing and Risk (DCR)**
  - Director, Brian Bussey (Sept. 28, 2017)
  - Previously held various leadership positions at the SEC since 1998
- **Division of Enforcement (DOE)**
  - James McDonald (March 30, 2017)
  - Previously, US Attorney's Office for the Southern District of New York, served as an Assistant US Attorney and most recently in the Public Corruption Unit
  - Updated Cooperation and Self-Reporting Guidance

“Core Principles” Executive Order

- On February 3, President Trump signed an Executive Order laying out “core principles” to guide the regulation of the US financial markets, which are:
  - Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth
  - Prevent taxpayer-funded bailouts
  - Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry
  - Enable American companies to be competitive with foreign firms in domestic and foreign markets
  - Advance American interests in international financial regulatory negotiations and meetings
  - Make regulation efficient, effective, and appropriately tailored
  - Restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework

“Core Principles” Executive Order

- The Order required the Secretary of the Treasury to submit a report to President Trump in early June that outlines how existing regulations promote or inhibit the core principles.
- In preparing this report, the Secretary of the Treasury was required to meet with:
  - Board of Governors of the Federal Reserve System,
  - Commodity Futures Trading Commission,
  - Federal Deposit Insurance Corporation,
  - Federal Housing Finance Agency,
  - National Credit Union Administration,
  - Office of the Comptroller of the Currency,
  - Securities and Exchange Commission,
  - Department of the Treasury, and
  - Consumer Financial Protection Bureau.

Treasury Report(s)

- "A Financial System That Creates Economic Opportunities"
  - June 12 – Banks and Credit Unions
  - October 6 – Capital Markets
  - ***October 26 – Asset Management and Insurance***
  - Q1 2018 – Non-Banks, Financial Technology and Cybersecurity

Speech by Chair Clayton – Nov. 8

- “Governance and Transparency at the Commission and in Our Markets”
  - SEC
    - Regulatory proportionality
    - Shorter near-term agenda for rulemaking
    - Longer-term agenda: shareholder engagement and participation
  - Markets
    - Eliminating wrongdoing before enforcement
    - “Where opacity exists, bad behavior tends to follow”
    - Complex, obscure or hidden fees
    - Initial Coin Offerings (ICOs)

TREASURY REPORT: NEW APPROACHES FOR US REGULATORS

A New Approach for US Regulators

- International Engagement
- Systemic Risk, Solvency, & Stress Testing
- Dual SEC and CFTC Registration for Advisers
- Asset Management Reporting and Disclosure Requirements
- Economic Growth and Informed Choices
- Volcker Rule

International Engagement

- Prevalence of US firms among world's largest asset managers
- US regulators as leaders
  - SEC should remain primary regulator in US
  - US regulators in leadership roles of international standard-setting bodies
    - FSB
    - IOSCO

Systemic Risk, Solvency, & Stress Testing

- Moving away from entity-level bank regulation
- Regulating high-risk activities instead
  - Both in the US and Internationally
  - Entities with above-average engagement in these high-risk activities
- Treasury recommends amendment of Dodd-Frank
  - Eliminate stress-testing requirement

Dual SEC and CFTC Registration for Advisers

- Significant overlap between two reporting regimes
- “Harmonize regulation”
- Provide exemptions from dual registration, where appropriate

Reporting and Disclosure Requirements

- Discrepancies between SEC and CFTC reporting formats
  - Timing
  - Costs
- SEC and CFTC must align their formats
- Redouble efforts to protect reported information

Economic Growth and Informed Choices

- Collaboration among the SEC, DOL, and state insurance regulators to create a regulatory framework that:
    1. Preserves choice; and
    2. Protects investors
- Address conflicts of interest without limiting investment options

Volcker Rule

- Picks up thread from prior Treasury report
- Reduce impact of Volcker Rule on asset managers and investors
- Relax restrictions on funds with names referring to a bank

Business Continuity and Transition Planning

- Need for strong continuity planning
- Transitioning of client accounts by investment advisers usually seamless
- Because both the Advisers Act and Investment Company Act effectively already require continuity plans, the SEC should withdraw its Advisers Act rule proposal

Liquidity Risk Management

- Rule 22e-4 under the Investment Company Act
  - Too restrictive an approach to liquidity risk management
  - Supportive of codifying 15% limitation on illiquid assets
  - Instead, SEC should implement a principles-based approach
  - Recommends postponement of the December 2018 implementation date
    - *(Note: ICI also requested a delay on November 3, 2017)*

Investments in Derivatives

- Generally supportive of modernizing the regulation of investment companies' use of derivatives
- Concerns with portfolio limits, reporting requirements, use of gross notional exposure and limits on assets available for segregation (i.e., cover positions)
- Supportive of derivatives risk management program
- Supportive of asset segregation, but with broader range of qualifying assets

ETFs

- Advocates reduction in time/cost barriers to entry for plain vanilla ETFs to enter the marketplace
- SEC Staff reportedly already working on revisiting 2008 ETF rule proposal

WHAT TO EXPECT IN 2018

New Developments at the CFTC

- **LabCFTC** (May 2017) – Daniel Gorfine, Director
  - "dedicated to facilitating market-enhancing financial technology (FinTech) innovation, fair market competition, and proactive regulatory excellence and understanding of emerging technologies"
- **Market Surveillance Branch** moved from DMO to DOE (March 2017)
- **Market Intelligence Unit** (March 2017) within DMO – Andrew B. Busch, Chief Market Intelligence Officer
- **Regulatory Reform Officer** (March 2017) – Mike Gill
  - "**Project KISS**"—Agency wide review of CFTC rules and practices to make the application of the rules simpler, less burdensome and less costly for market participants

SEC 2018 Examination and Enforcement

- Expecting to see substantial focus on retail investors and retail products, particular retirement channels and seniors
- Expecting a much more hands-off approach for private products available only to financially sophisticated investors

SEC 2018 Examination and Enforcement

- Expect a slowdown in IA and IC rulemaking over the next few years
  - Performance [?]
- Share class cases
  - *SunTrust* case, where the firm did not state that it shared in 12b-1 fees with IARs or that other share classes were available
  - *Cadaret Grant* case
- Retirement
  - The Retirement Initiative likely will be substantially escalated in 2018
  - Key area of focus and concern for SEC Chair Clayton
  - “Mr. & Mrs. 401(k)”

SEC 2018 Examination and Enforcement

- The wrap program initiative will also continue into 2018, partly in conjunction with the focus on seniors and retirement accounts
  - Of particular focus will be where additional fees are charged outside the program
  - Note: Investor Bulletin issued on December 7
- Predictions for 2018 exam priorities list:
  - Focus on retail and senior investors
  - Much less focus on private funds
  - Wrap programs, suitability and fees (particularly with seniors)
  - Orphaned accounts (i.e., where a Rep leaves a firm, but the account stays behind and continues to be charged fees)

SEC 2018 Examination and Enforcement

- Cyber security issues will still be part of risk-based examinations
  - Firms should look at the releases that have been published, including the OCIE Risk Alerts
- Examiners continue to work with DERA and the OCIE quantitative group to mine a lot of data to drive examinations based on risk assessment
  - In particular, they are looking at data patterns on trading, best execution, trade allocation and self-dealing
  - The staff leverages blue sheet information and tips from FINRA for best execution matters
- Adviser registration statements (Form ADV)
  - Given the recent changes to the form (e.g., separate account information), this will likely be an area of regional examination initiatives next year
- Custody
  - Confusion of inadvertent custody and standing letters of authorization

Biography

Jack O'Brien
Philadelphia
T +1.215.963.4969
john.obrien@morganlewis.com

John J. "Jack" O'Brien counsels registered and private funds and fund managers in connection with organizational, offering, transactional, and compliance matters. He regularly works with a variety of different fund structures, including open-end and closed-end funds, exchange-traded funds, and hedge funds. He also counsels investment adviser and broker-dealer clients on various matters, particularly with respect to registration and disclosure, marketing regulations, pay-to-play issues, and transactions in exchange-traded funds.

Biography

Michael Philipp
Chicago
T +1.312.324.1905
michael.philipp@morganlewis.com

Michael M. Philipp counsels financial services clients in futures and securities transactions. He also advises them in derivatives regulation, legislation, compliance, and enforcement matters. United States and foreign exchanges and clearing organizations, banks, investment managers, proprietary trading firms, brokerage firms, and end users turn to Michael for guidance in connection with exchange-traded and over-the-counter derivative instruments. He also represents foreign exchanges and clearinghouses in their US offerings of futures and equity options products and derivatives clearing activities.

Biography

Joshua Sterling
Washington, DC
T +1.202.739.5126
joshua.sterling@morganlewis.com

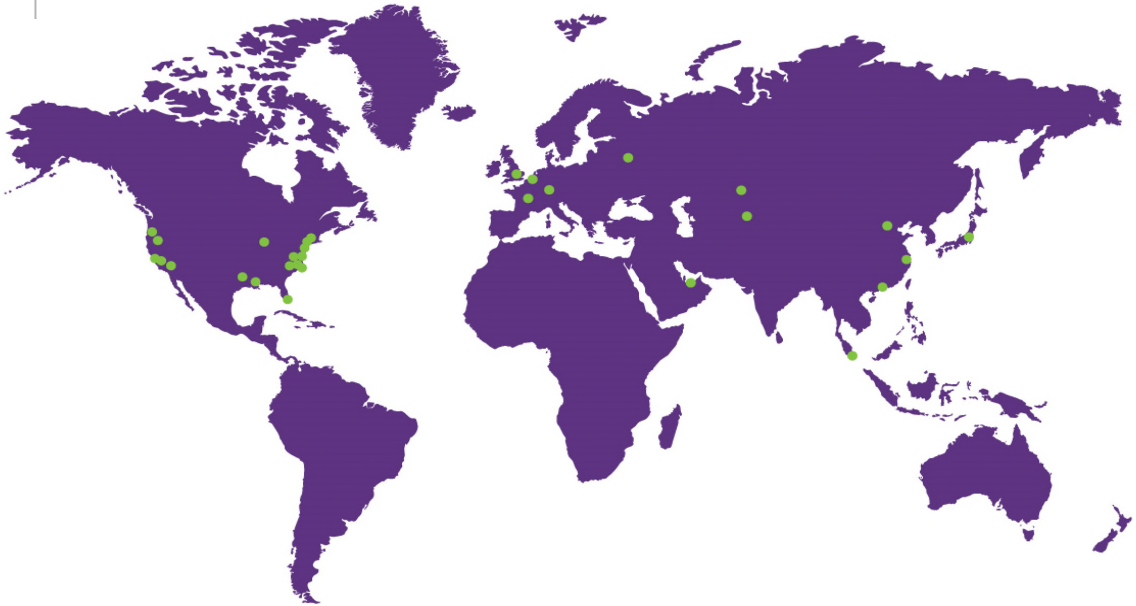
Josh Sterling represents managers of private and public funds globally, including the sponsors of hedge funds, registered investment companies, and other pooled investment vehicles. He helps these clients develop and offer their products and services in the United States. Josh also assists managers of alternative investment strategies in structuring their derivatives activities in compliance with the Dodd-Frank Act and related US Securities and Exchange Commission (SEC) and US Commodity Futures Trading Commission (CFTC) requirements.

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty
Astana
Beijing*
Boston
Brussels
Century City
Chicago
Dallas
Dubai
Frankfurt
Hartford
Hong Kong*
Houston
London
Los Angeles
Miami
Moscow
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



Morgan Lewis

*Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners.

THANK YOU