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The Future of Investment Management Regulation: What to Expect in 2017

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In this fast-changing regulatory environment, the long-term consequences – both intended and unintended – of recent White House actions remain uncertain, but looking into our crystal ball, we see certain trends emerging. These trends may lead to long-term shifts in how the Securities and Exchange Commission approaches regulation and enforcement, but, at least in the short-term, we see little change in the oversight responsibilities of fund directors.

Of course, while nobody knows for sure what the future will bring, we've made our best guess.

WHITE HOUSE ACTIONS

- *Presidential "TwoFer" Order.* By Presidential Executive Order dated Jan. 30, unless prohibited by law, when an "executive department or agency publicly proposes for notice and comment or otherwise promulgates a new regulation, it shall identify at least two existing regulations to be repealed." The TwoFer Order requires agencies to offset any new incremental costs associated with new regulations, to the extent permitted by law, with the "elimination of existing costs associated with at least two prior regulations."

  Three days later, the White House published a memorandum that clarified that the TwoFer Order does not apply to independent regulatory agencies, including the SEC, the Federal Reserve and most bank regulators. Nevertheless, the memorandum said, "we encourage independent regulatory agencies to identify existing regulations that, if repealed or revised, would achieve cost savings that would fully offset the costs of new significant regulatory actions."

  The real issue is whether the White House will ask the new SEC chair to comply voluntarily with this order. It may prove difficult for the new chair to say no.

  We believe the real issue here is regulatory costs, not the number of regulations. The Feb. 2 White House Memorandum explained that agencies may comply with this requirement by issuing two "deregulatory" actions for each significant regulatory action that imposes costs, resulting in a full cost offset.

  Federal law requires the SEC to estimate the costs of implementing a new rule and publish those estimates in the Federal Register. It appears to also apply to amendments to existing rules.

  If the SEC voluntarily complied with the TwoFer Order, the SEC would be busy keeping a score card as it identifies costly rules to cut back when it adopts new rules. Some rules, like Rule 30e-2, may actually reduce regulatory compliance costs. It is not clear whether the SEC would receive a cost "credit" against future regulatory costs.

- *Presidential Order establishing "Core Principles" for regulating financial institutions.* A February 3, 2017 Presidential Order established six "Core Principles" for regulating the U.S. financial system:

  (a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth;

  (b) prevent taxpayer-funded bailouts;

  (c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazards and information asymmetry;

  (d) enable American companies to be competitive with foreign firms in domestic and foreign markets;

  (e) advance American interests in international financial regulatory negotiations and meetings; and

  (f) restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework.

  The order directs the secretary of the Treasury to consult with the SEC chair and other members of the Financial Stability Oversight Council to identify laws, treaties, regulations or guidance that inhibit federal regulation of the financial system consistent with the core principles. The order seeks to identify existing laws and rules for repeal.

- *Presidential Memorandum concerning the DOL fiduciary rule.* The controversial fiduciary rule adopted in April 2016 is set to be implemented on April 10, 2017 and is subject neither to the Priebus regulatory freeze nor the Presidential TwoFer Order.

  On February 3, 2017, memorandum to the secretary of labor, the White House directed the Department of Labor to review the fiduciary rule to consider whether it should be modified or rescinded. The president's order instructed the DOL to consider whether the fiduciary rule would

  - harm investors' access to financial advice and certain retirement products;
  - disrupt the retirement services industry in a manner that would adversely affect investors; and
  - cause an increase in litigation or the prices investors would pay to gain access to retirement services.

If, after completing its review, the DOL concludes that the fiduciary rule would adversely affect investors, then it must publish for notice and comment a rule that would rescind or revise it.

The memorandum stopped short of delaying the April 10, 2017 implementation date. The White House, however, reportedly is asking to delay implementation by 180 days, presumably to allow time for the DOL to propose a rule that amends or revokes the fiduciary rule. At this point, the future of the fiduciary rule is not clear. Whether the DOL delays, or proposes to revise or revoke, the fiduciary rule, many broker-dealers are already moving toward adopting a fiduciary standard for retirement accounts.

RULES REGULATING INVESTMENT COMPANIES AND ASSET MANAGERS

- *Mutual fund use of derivatives.* Final rules to regulate mutual fund use of derivatives and require funds to adopt enhanced risk management measures were wrapped up, tied with a bow, and ready for consideration by the SEC last December. Proposed Rule 18f-4 under the 1940 Act was a casualty of the inability of the SEC to rustle up a quorum of the three SEC commissioners, which precluded a vote. So, the rule remains a proposal. Given its complexity, we expect it is unlikely to see sunlight in its current form any time soon. This rule would likely increase compliance costs to funds and investment advisers.

- *Web-based transmittal of shareholder reports.* Proposed Rule 30e-3 under the 1940 Act would provide an optional method for investment companies to transmit shareholder reports through the fund's website. While this proposal also fell victim to the SEC's December quorum conundrum, this proposal is more likely to proceed because Acting Chair Michael Piwowar supported it. This rule would likely decrease costs to funds and shareholders.

- *Registration of investment advisers.* In 2011, the SEC adopted rules that required investment advisers to private funds to register if they met certain statutory thresholds for assets under management. The new rules also created exemptions for advisers to venture capital funds, private fund advisers with less than $150m in AUM, and private fund advisers. These rules implemented parts of the Dodd-Frank Act. Despite calls from some quarters to repeal Dodd-Frank, we do not believe Congress will rush to repeal these provisions.

- *Venture capital funds.* The Financial CHOICE Act (H.R. 5983) would broaden the exemption from the definition of an investment company for venture capital funds. Currently, to qualify for the small fund exemption, a venture capital fund can have no more than 100 beneficial owners. The proposal would expand this limitation to no more than 250.

- *Security-based swap intermediaries.* The SEC was set to finalize rules regarding capital margin requirements for security-based swap intermediaries. In the waning days of Chair Mary Jo White's SEC tenure, it appeared the commissioners would unanimously adopt these rules, but again fell victim to the inability to muster a quorum. Given that these rules are relatively non-controversial, and with Piwowar's support, the newly composed SEC may proceed to adopt them. This rule likely would increase costs.

- *Existing rules at risk.* Over the past three years, the SEC has published several high-profile rules that required funds and advisers to overhaul operations and compliance, including the money market reform rules, liquidity risk management programs, investment company reporting modernization, swing pricing and amendments to Form ADV and reporting rules under the Investment Advisers Act.

Some of these rules, like the liquidity risk management rule adopted in October 2016, may present tempting targets. The SEC estimated that its one-time cost for funds ranges from $800,000 to $10.2m, with an average cost per fund complex of $1m, and an aggregate industry cost of $855m. This doesn't include indirect costs funds will pay to lawyers and accountants to revise policies and procedures and compliance reporting, and costs attributable to compliance with the companion reporting modernization rules.

While it is not likely the newly constituted SEC will act swiftly to eliminate the reporting or other rules, the SEC may pull back discrete parts that may reduce compliance costs, regardless of whether it says it will voluntarily comply with the TwoFer Order.

- *Examinations.* Under White, the Office of Compliance Inspections and Examinations adopted a risk-based and data-driven approach to investment adviser examinations. We expect this trend to continue and OCIE to pursue the examination priorities published in January 2017. Subsequent to the publication of the priorities, however, OCIE Director Mark Wyatt resigned, throwing into question whether a new director will establish the same priorities. It would be reasonable to expect OCIE to stay on this course, and we do not expect to see the pace of exams slow down.

- *SEC Regulatory Accountability Act.* Regardless of how the TwoFer order affects the SEC, a bill that the House passed on January 12, 2017, may further restrict the SEC's rulemaking ability if passed by the Senate and signed into law. The SEC Regulatory Accountability Act (H.R. 78) would require the SEC, before issuing a new regulation, among other things, to identify the problem that the rule is designed to address and ensure that the benefits justify the cost. The bill would also require the SEC to review periodically all regulations to determine if they are outmoded, inefficient or excessively burdensome.

FUND DIRECTORS AND COMPLIANCE OFFICERS

- *Investment company independent directors.* While oversight responsibilities may shift if the SEC modifies or pulls back on certain regulations, there is little to suggest that the well-established statutory and fiduciary oversight responsibilities of fund directors will change, at least in the short term. Whether or not the SEC pulls back on regulations or shifts its examination priorities, fund directors will continue to be responsible for approving investment advisory contracts and distribution plans, reviewing compliance programs, and monitoring portfolio performance and conflicts of interest, among other things. If anything, the oversight role of independent directors may grow if the SEC shifts away from specific rules to a more principles-based approach.

- *Chief compliance officers.* Similarly, the role of chief compliance officers and compliance personnel is not likely to diminish any time soon, and may grow if the SEC trends toward a more principles-based approach.

CONCLUSION

While we don't foresee the SEC rushing to repeal existing rules, we don't expect to see a clamor to adopt new ones either. The overall pace of rulemaking may slow, but not grind to a halt. We expect the SEC to proactively expand or contract regulations indirectly through new guidance and interpretations, which bypass the formal regulatory process. And in the process, the role of fund directors likely will grow as the SEC shifts toward a more principles-based approach to regulation.

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