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Big Regulatory Changes in Store for Funds and Advisers? No One Knows for Certain, but Here’s Our Best Guess

By Jay G. Baris

While no one knows for sure what the future holds for investment management regulation, the tea leaves indicate that we may expect a slowdown on new regulations, some pullback on parts of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”), and an abundance of uncertainty. Here, we provide some observations for investment companies, their independent directors, investment advisers, broker-dealers and other service providers that want a peek at how we see the future unfolding.

To be sure, the future doesn’t look the same as it did in October. Prior to the election, the Securities and Exchange Commission (SEC) pursued Chair White’s regulatory and enforcement agenda for investment companies and investment advisers, and certain elements of the Senate sought an even more aggressive agenda by molding the SEC to meet its populist objectives.

But with the election of Donald J. Trump, suddenly everything is on the table. While little was said during the campaign about financial regulations (let alone about mutual funds), the future of Dodd-Frank, or at least portions of it, the Department of Labor’s conflicts of interest rule (the “fiduciary rule”), the pending mutual fund derivatives rule and other regulatory initiatives now seem uncertain.

For a peek at what the future may hold, we start by looking at the President-elect’s transition team, and by dusting off a piece of legislation introduced earlier this year by Representative Jeb Hensarling, a Texas Republican who chairs the House Financial Services Committee.

Transition team. The President-elect’s appointment of Paul Atkins, a former SEC Commissioner, to the transition team may give us a window into his thinking. Mr. Atkins is generally viewed as against heavy regulation, and when he was a Commissioner, he was a frequent dissenter. The President-elect also appointed Anthony Scaramucci, the co-managing partner of SkyBridge Capital, known for his conservative views toward regulation and his vocal opposition to the fiduciary rule, to his team.

The Financial CHOICE Act. Representative Hensarling’s 512-page bill, the Financial CHOICE Act of 2016, H.R. 5983 (known as the “CHOICE Act”), if enacted in its current form, would surgically dismantle major features – but certainly not all – of Dodd-Frank. Before November, this bill appeared to have little chance of going anywhere. But the bill, which the House Financial Services Committee passed by a vote of 30-26 on September 13, 2016, may serve as a harbinger of things to come.

What's coming down the road? Here is a guess of the changes to come. Rather than attempt to analyze how the new administration will address all issues relating to financial institutions, we focus on a few of the areas about which investment companies, investment advisers and fund directors may be most concerned.

The Securities and Exchange Commission. Perhaps the greatest change that will affect investment companies, advisers and fund directors is the composition of the SEC. Currently, there are two vacancies. When the new President appoints a new chair to succeed Mary Jo White, who recently announced her retirement, the SEC will be on a path to Republican majority leadership for the first time in eight years.

What could the SEC look like? The transition team may recommend Michael Piwowar, one of the three current Commissioners and the sole Republican, as Chair. It may also recommend Daniel Gallagher, another former Republican Commissioner (and Mr. Atkins' current partner at Patomak Global Partners, LLC, a Washington-based financial services consulting firm) or even Mr. Atkins himself to be the next Chair. The *Wall Street Journal* reported that the President-elect is considering Debra Wong Yang, a former U.S. attorney in Los Angeles to serve as Chair. In any event, with a majority of Commissioners who favor less, rather than more, regulation, we are likely to see the pace of new regulatory proposals slow and some subtle changes in enforcement trends.

Enforcement. Don't expect to see a wholesale halt of enforcement actions alleging fraud or corporate misdeeds. Rather, we can expect more levels of review and caution. The CHOICE Act contains broad-stroke steps designed to ensure "fair treatment during the course of SEC investigations," by expediting resolution, establishing an Enforcement Ombudsman to review and evaluate complaints about the enforcement process, and prohibiting use of novel unproven legal theories (e.g., "collective scienter") that would overstep existing legal boundaries. The CHOICE Act would also require more transparency into the enforcement process, and would let certain defendants appear before the SEC after receiving a Wells notice, *before* the SEC votes to bring an action.

The CHOICE Act would also strengthen certain penalties for fraud and deception. For example, it would allow the SEC to triple the amount of fines it assesses for certain violations.

The Volcker Rule. The CHOICE Act would repeal the Volcker Rule (Section 619 of Dodd-Frank). The Volcker Rule generally limits certain types of trading by banks and bank holding companies, specifically trading for their own account (i.e., proprietary trading), or sponsoring or owning an interest in a private fund (e.g., a hedge fund).

The Volcker Rule has been a thorn in the side of the financial services industry since its adoption, and investment banks have spent millions of dollars on compliance. While a repeal of the Volcker Rule would not affect registered investment companies directly, it would benefit investment advisers that are part of bank holding companies, and remove some capital-raising barriers for private funds.

Systemically important financial institutions (SIFIs). Dodd-Frank created the Financial Stability Oversight Council (FSOC) with a three-fold purpose to:

- Identify risks to the financial stability of the U.S. that could result from financial distress or failures of financial institutions;

- Promote market discipline so that private companies do not expect government bailouts; and
- Respond to emerging threats to the stability of the U.S. financial system.

Dodd-Frank empowered FSOC to designate certain non-bank financial institutions as SIFIs. A SIFI designation means that a financial institution would be subject to capital requirements and more rigorous prudential regulation, which in essence allows FSOC to regulate a non-bank as if it were a regulated bank. Investment advisers, investment companies and insurance companies chafe under this law because, they argue, a SIFI designation results in massive compliance costs and other unintended consequences that may result in more, not fewer, risks.

The CHOICE Act would repeal FSOC's authority to designate SIFIs, and would retroactively repeal its previous designations of non-bank financial companies. This repeal would be welcome relief for large investment companies and their advisers, who face the threat of SIFI designation and all that comes with it.

Even if the House passes the CHOICE Act as approved by the Committee, it must still pass the Senate, where passage is not guaranteed. We expect that the Senate may require legislators to reach a compromise on some of the more controversial proposals, such as repeal of the Department of Labor (DOL) fiduciary rule or the Volcker Rule, so at this time, it is not possible to predict how much different the final bill will look from the version passed by the Committee.

The DOL fiduciary rule. Section 913 of Dodd-Frank authorized, but did not require, the SEC to establish a uniform standard of care for broker-dealers and investment advisers, and required the SEC to study and report on the issue. In 2011, the SEC staff published a report recommending that the SEC establish a uniform standard of care.

The SEC, however, was split on the merits of the recommendation, and before the SEC acted, the Department of Labor did an end run. With great fanfare, the Department finalized rules that impose a fiduciary standard on all who provide retirement investment advice to ERISA plans, plan fiduciaries and IRAs. That is, they must put their clients' best interests, before their own profits. These rules become effective in April 2017.

While the concept of the new rules is simple, implementation is not. Implementation of the fiduciary rule has already resulted in enormous compliance costs, and will have a trickle-down effect as investment companies scramble to reconfigure their product offerings to meet demands of brokers and intermediaries who sell their products to retirement investors. Another complication is that the SEC has yet to propose rules that would impose a fiduciary standard on broker-dealers that sell investments to non-retirement accounts.

Members of the President-elect's transition team have vocally opposed the fiduciary rule, asserting that it would actually reduce investment choices for lower-income families that cannot obtain the services of investment advisers, thus forcing them to accept less expensive retirement alternatives such as robo-advisers.

The new administration has a few options available for the fiduciary rule:

- Let the fiduciary rule go into effect and address changes later (most likely). The fiduciary rule becomes effective not quite three months after the new president takes office. That does not leave much time to change or repeal the rule.

- Immediately repeal the fiduciary rule (least likely). At the Department of Labor level, this option would take considerable time because of the long lead time to propose and implement a total repeal.
    - The CHOICE Act would repeal the DOL's rule by an act of legislation, and would restrict the DOL from adopting a similar rule until after the SEC issues a final rule under its Section 913 of the Dodd-Frank authority. Moreover, the CHOICE Act would require that before the SEC adopts its own rule, it must fully analyze how the rule could affect the availability of retirement products and access to investment advice for retail investors. (Because of timing issues the Congressional Review Act does not appear to be a vehicle for overturning the fiduciary rule.)
- Delay implementation. More likely, the new administration would delay the implementation of the rule, scheduled for April 2017, to give it more time to figure out a more efficient way to dismantle it. Like others before him, Mr. Trump may put a moratorium on this and other pending regulations early in his term while he and his advisers consider how to proceed.
- Not fight court challenges. Another path is for the new administration simply not to fight court challenges to the rule, and let the courts potentially invalidate the rule by declaring victory to the challengers without opposition. This assumes, however, that the courts will not permit third parties to defend the DOL's rules.

It is not clear at this point how the new administration is likely to proceed.

Use of derivatives by investment companies. In late 2015, the SEC proposed rules that would limit investment company use of derivatives and leverage. The rules would require registered investment companies to comply with one of two alternative portfolio limitations, establish new asset segregation requirements and require certain funds to adopt derivatives risk management programs.

This proposal was one of the key elements of Chair White's initiatives to identify and manage systemic risks presented by investment companies. It is now all but certain that the SEC will not adopt the final rule before her term ends in January 2017. It is possible, even likely, that the new SEC leadership will let this proposal hang in regulatory limbo until it can come up with a new approach.

Liquidity risk management. This train has left the station. It is unlikely that the SEC will pull back on the liquidity risk management rules that it recently adopted any time soon. But of course no one knows for sure.

Exchange-traded funds (ETFs). In May 2016, Chair White mentioned that the SEC's staff was looking at the interconnectedness of the prices of ETF shares and their portfolio holdings and the impact on investors when ETF arbitrage mechanisms do not function properly. She said that the staff was also looking at broker-dealer sales practices involving ETFs in particular. It is not clear at this point if the newly constituted SEC leadership will take any action on this issue.

Money market reforms. With money market reform largely completed, and with millions of dollars spent on implementation, it is unlikely that the SEC will undo the "floating NAV" rule. The SEC may take additional action if money market funds come under pressure in a new financial crisis, but that would have been the case no matter what occurs with the SEC leadership.

Regulation of investment advisers. Pre-Dodd-Frank, an investment adviser with fewer than 15 clients was exempt from registration. Hedge funds and private equity funds, no matter how large, were counted as one client. Dodd-Frank eliminated this exemption and, instead, requires an investment adviser with more than $150 million of assets under management to register, regardless of how many funds it advises, although advisers to venture capital funds that meet certain conditions are exempt from this registration requirement.

The CHOICE Act would repeal the provisions in Title V of Dodd-Frank concerning registration and examination requirements for investment advisers to private equity funds, and align the requirements to those that apply to venture capital funds. Otherwise, we do not expect that the new administration will support the repeal of any other provisions of Title V of Dodd-Frank.

Accredited investors. Rules under the Securities Act of 1933 ("1933 Act") define the minimum financial requirements for "accredited investors" who are eligible to invest in unregistered private funds. Investors in mutual funds are not subject to minimum financial requirements because they enjoy the investor protections of the Investment Company Act of 1940 and the 1933 Act. The CHOICE Act would amend the definition of accredited investor to expand the pool of eligible investors in private securities offerings.

Business development companies (BDCs). The CHOICE Act would incorporate the provisions of the Small Business Credit Availability Act, which was previously approved by the House Financial Services Committee. Among other things, that bill would ease leverage restrictions on BDCs.

Other provisions of the CHOICE Act. The CHOICE Act would also:

- Eliminate the Office of Financial Research (OFR), formed to support FSOC. The OFR famously concluded that asset managers may present systemic risks to the U.S. financial system;
- Eliminate restrictions on executive compensation contained in Title IX of Dodd-Frank;
- Repeal the "Durbin Amendment" of Dodd-Frank, which restricted interchange fees that banks can charge on credit card transactions;
- Reform the mission of the Consumer Financial Protection Bureau (CFPB); and
- Much, much more.

Our Take

The bottom line: Expect some significant changes in some significant areas. When and where, and to what extent, are far from certain.

Meanwhile, until we learn otherwise, prudence dictates that we must proceed with compliance schedules and implementation of newly adopted regulations (e.g., the fiduciary rule and liquidity risk management) as planned, but step back and watch what happens on other SEC initiatives before making any dramatic changes in compliance approaches (e.g., derivatives risk management).

Contacts:

Jay Baris
(212) 468-8053
jbaris@mofo.com

Oliver Ireland
(202) 778-1614
oireland@mofo.com

Kelley Howes
(303) 592-2237
khowes@mofo.com

Matthew Kutner
(212) 336-4061
mkutner@mofo.com

Hillel Cohn
(213) 892-5251
hcohn@mofo.com

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