Jay G. Baris

Market Trends: Investment Companies

by Jay G. Baris, Morrison & Foerster LLP

Overview

Regulatory and market trends for investment companies are beginning to emerge in 2017. It appears likely that the pace of new regulations and enforcement actions will slow from the rate in the last few years as the new Securities and Exchange Commission (SEC) chair takes office, especially if the Trump administration proposes to cut the SEC's budget. New regulatory initiatives may modify or pull back on some old ones, and the enforcement staff may shift its focus to major frauds and away from policing minor rules (known as the broken windows approach). In past years, many criticized the broken windows approach as a misplaced use of limited resources. This note discusses trends in 2016 and how the newly constituted SEC may regulate and police investment companies, as well as where the market is headed in the coming months. For further information on investment companies in general, see Investment Company Classification and Operations, Registering Investment Companies with the SEC, and Complying with Key Restrictions for Investment Companies.

Legal and Regulatory Trends

Over the past two years, the SEC adopted several significant rules relating to investment companies and investment advisers, reflecting the prior chairman's priorities and approach for new rules to enhance investor protection in light of the financial crisis of 2008. These rules required, among other things:

- Liquidity risk management programs for investment companies
- Modernization of investment company reporting
- Enhanced reporting for investment advisors
- Funds to be given option to use swing pricing

When former SEC Chair Mary Jo White left office in January 2017, she left behind a wish list of unfinished business. It is not certain whether the SEC following her departure will adopt any of the rules championed by the former chair, because Jay Clayton, the new chair, may establish different priorities.

Investment Company Use of Derivatives and Leverage

For more than 30 years, the SEC and its staff have been improvising on how, and to what extent, investment companies can use derivatives. When Congress adopted the Investment Company Act of 1940, as amended (Investment Company Act), derivatives, as we know them today, had not yet been invented. Yet, over the past 30 years, these instruments grew in popularity as mutual fund assets, and Wall Street's financial ingenuity grew exponentially in response to investor demands. Regulatory bodies and fund managers struggled to find a way to let funds use derivatives to create leverage and new strategies within the Investment Company Act's legal parameters, which proved a challenge.

Beginning in 1979, with Release No. IC-10666 (known as Release Ten-Triple-Six), the SEC and its staff paved the way for the use of derivatives by addressing how funds can employ limited leverage techniques, such as reverse repurchase agreements, if they cover potential liabilities that the leverage created. This interpretation led to a patchwork of guidelines and interpretations designed with the twin goals of encouraging innovation and protecting investors. These twin goals often presented challenges, because the regulatory framework originally established was not built to anticipate derivatives.

The 2008 financial crisis increased the focus on fund use of derivatives and leverage, as the SEC became concerned that its patchwork of regulations and interpretations may not be sufficient to protect investors if the financial markets endure another global liquidity catastrophe. After years of studies, concept releases, and feedback from fund managers and bar associations, the SEC proposed Rule 18f-4 to address fund use of derivatives in 2015. See Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Rel. No. 31933 (December 11, 2015). This controversial rule would have codified many existing interpretations of the law, and would have imposed substantive limits on derivatives use, require funds to segregate cash to cover potential liabilities, and require funds to establish specific policies and procedures designed to monitor compliance. Moreover, the rules would have required fund directors to actively oversee fund use of derivatives with an amount of substantive detail not previously seen.

This initiative came to a grinding halt immediately after the 2016 presidential election. The rule's adoption fell victim to a stalemate at the SEC, which could not muster a quorum to vote on a final rule.

As of this writing, it appears that the Rule 18f-4 initiative, in its current form, is dead, especially in an environment that seems to emphasize less, rather than more, regulation. For the time being, funds and advisers must rely on the status quo patchwork of guidance and interpretations. For additional information on derivatives in general and in various contexts, see Understanding Financial Derivatives, Knowing the Essentials of Equity Derivatives, Learning the Fundamentals of Credit Derivatives , and Key Aspects of Synthetic CDOs.

Liquidity Risk Management

With great fanfare in 2016, the SEC adopted new rules that require funds to adopt specific liquidity risk management programs, comply with substantive limits on investments in illiquid securities, and categorize and report liquidity levels. See Investment Company Liquidity Risk Management Programs, Investment Company Act Rel. No. 32315 (Oct. 13, 2016). Funds must begin to comply with the new requirements in 2018, which for many fund advisers will involve substantial and costly enhancement in systems and compliance personnel. The SEC estimated that the one-time cost for funds ranges from $800,000 to $10.2 million, with an average cost per fund complex of $1 million, and an aggregate industry cost of $855 million. This doesn't include indirect costs funds will pay to lawyers and accountants to revise policies and procedures and compliance reporting or costs attributable to compliance with the companion reporting modernization rules. For these reasons, fund complexes may ask for delays in implementation pending further cost-benefit analysis. Further delays would be consistent with an SEC that leans toward deregulation due to the new Trump administration.

Fiduciary Rule

The Department of Labor, or DoL, deferred the effective date of its fiduciary rule until June 9, 2017, rather April 10, 2017, pending further review. The rule, adopted in 2016, treats advisors to retirement investors as fiduciaries who have an obligation to give advice that adheres to "impartial conduct standards." See Definition of the Term "Fiduciary;" Conflict of Interest Rule – Retirement Investment Advice (April 1, 2016), 81 F. Reg. 68, at 20946 (April 8, 2016).

The delay followed a February 3, 2017, presidential memorandum that directed the DoL to examine the fiduciary rule to ensure that it does not adversely affect the ability of Americans to gain access to retirement information and financial advice.

The fiduciary rule generally imposes a fiduciary standard on broker-dealers that sell investments to qualified retirement accounts and individual retirement accounts (IRAs). Currently, broker-dealers are held to a suitability standard, which means that they can recommend an investment as long as it is suitable for a client. For additional information on the current standard, see FINRA Rule 2111 and Broker-Dealer Suitability Obligations. The fiduciary rule would not apply to non-retirement accounts, which only the SEC could regulate.

While it does not apply directly to investment companies, the fiduciary rule affects them because financial intermediaries may require them to change their fee structures to accommodate their compliance requirements.

While the future of the DoL's rule remains uncertain, two trends appear to be emerging: First, many intermediaries and funds have changed their market practices to comply with the concepts in the DoL rule, a trend that may continue whether or not the DoL rule ever goes fully effective. Second, the SEC must decide whether to adopt its own version of a fiduciary rule (which the SEC supported after conducting a study required by Section 913 the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act or the Act) (111 P.L. 203, 124 Stat. 1376). See "Study on Investment Advisers and Broker-Dealers as Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act" (January 2011). An SEC rule would cover all securities investments, rather than just retirement accounts, which would provide more consistency. For additional information on the Dodd-Frank Act, see The Dodd-Frank Wall Street Reform and Consumer Protection Act: Road Map to Key Provisions.

The DoL rule's requirements by themselves are untethered from the federal securities laws, creating potential for overlap and contradictory requirements. Of course, it is not certain whether either the DoL or the SEC will proceed with separate rules, coordinated rules, or any rules at all.

Disclosure Trends

The SEC continues to emphasize the need for funds to disclose risks relating to changing market conditions. For example, the staff of the SEC's Division of Investment Management published guidance in 2016 that encouraged registered funds to:

- Continually review the adequacy of disclosures concerning market conditions and their impact on fund risks
- Continually review whether fund risks have been adequately communicated to fund investors in light of current market conditions
- Update communications to investors as needed

See Division of Investment Management, IM Guidance Update No. 2016-01 (March 2016), Division of Investment Management, IM Guidance Update.

The liquidity risk management rule, which phases in beginning in 2018, would also require funds to publicly disclose more information about their liquidity profiles, including the aggregated percentage of its portfolio representing each of four liquidity classification categories required by the SEC.

In 2016, the SEC finalized new rules that will require funds to report more information about their portfolio holdings, including their derivatives positions and securities lending activities. See Investment Company Reporting Modernization, Investment Company Act Rel. No. 32314 (October 13, 2016).

In 2017, we expect to see a slowdown in regulatory initiatives that would require incremental disclosure and reporting responsibilities, and a focus more on enforcing existing disclosure requirements.

New Legislation

On April 27, 2017, House Financial Services Committee Chairman Jeb Hensarling (R-TX) introduced H.R. 10, the Financial CHOICE Act of 2017. The bill, known as CHOICE Act 2.0, is a revised version of a bill introduced in 2016. It contains regulatory relief for investment companies, business development companies, and venture capital funds.

Of particular interest to investment companies is a provision that would tighten the burden for plaintiffs to prove that an investment advisor breached its fiduciary duty with respect to its receipt of advisory fees. These lawsuits, which have proliferated in the past several years, are known as excessive fee cases, because they allege that investment advisers charged investment companies fees that were too high. The bill would require plaintiffs to "state with particularity" allegations that an adviser breached its fiduciary duty, and to prove a breach of fiduciary duty "by clear and convincing evidence."

CHOICE Act 2.0 would ease restrictions on business development companies (BDCs) to allow additional leverage under certain circumstances. It would also exempt certain closely-held venture capital funds from the requirement to register as an investment company under the Investment Company Act if it has fewer than 500 investors (currently the limit is 100 investors). It would ease restrictions on the ability of BDCs to issue more than one class of equity securities. It would also streamline the process for applications for exemptions under the Investment Company Act.

It is too early to tell whether Congress will enact of the provisions contained in the Financial CHOICE Act 2.0, but the bill is consistent with the Trump administration's calls for deregulation of the financial institutions.

The Role of Investment Company Directors

As the growth, scope, and complexity of mutual funds, exchange-traded funds (ETFs), business development companies, and closed-end funds has grown over the past decade, so has the role of fund directors. Many directors and lawyers believe that this steady growth in responsibilities morphed the role of the fund directors from traditional oversight to one of micromanagement.

It would not be unreasonable to predict that the pace of growth of directors' responsibilities will slow, or even ease, as the pace and nature of new regulations itself slows down. 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. For additional information, see Understanding the Corporate Structure and Governance of an Investment Company. 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. For a discussion of some of these responsibilities, see Regulation of the Advisory and Underwriting Contracts under the Investment Company Act. If anything, the oversight role of independent directors may grow if the SEC shifts away from specific rules to a more principles-based approach.

Fund directors may seek relief from the growing burdens. For example, Section 2(a)(41)(B) (15 USCS § 80a-2(41)) of the Investment Company Act squarely places on fund directors the responsibility to determine in good faith the value of fund assets when market quotations are not readily available, but these requirements were imposed more than 75 years ago, when fund portfolios were much easier to value. There may be a push to ease some of these burdens.

Chief Compliance Officers

Similarly, the role of chief compliance officers (CCOs) and compliance personnel is not likely to diminish any time soon, and may grow if the SEC trends toward a more principles-based approach. And, the trend toward more oversight responsibilities for fund directors has translated into more pressure on CCOs, who serve as the eyes and ears, and sometimes the conscience, of fund boards. For additional discussion, see Personal Liability of Compliance Officers: Understanding and Mitigating the Risks.

Examinations and Enforcement

Over the past few years, the SEC's examination and enforcement programs reached new highs. In the SEC's 2016 fiscal year, the Office of Compliance Inspections and Examinations (OCIE) examined more than 2,400 regulated entities, an increase of more than 20 percent over 2015. OCIE's Investment Adviser/Investment Company program completed more than 1,600 examinations, representing an increase of 20 percent over fiscal year 2015. See "SEC Agency Financial Report, Fiscal Year 2016".

Similarly, the SEC brought a record 868 enforcement actions in fiscal year 2016, the most ever in a single year, with an emphasis placed on gatekeepers, such as fund directors, chief compliance officers, and independent auditors, and cases resulting from whistleblower filings. For additional discussion on SEC enforcement in the hedge fund context, see Market Trends: Hedge Funds.

Will these trends continue in 2017 and beyond? Of course, no one knows for sure, but if the SEC's budget is reduced, it would follow that the number of examinations and enforcement cases would drop, forcing the SEC to focus more on major wrongdoing and less on fixing broken windows.

Other Key Market Trends

The Investment Company Institute (ICI) reported that registered investment company assets exceeded a record $19 trillion in 2016, with open-end investment companies (mutual funds) accounting for more than $16 trillion in assets. The ICI noted, however, that mutual funds recorded $229 billion in net asset outflows in 2016. See Investment Company Institute 2017 Investment Company Fact Book.

The biggest growth area, however, appears to be with ETFs. From 2007 until 2016, total assets of U.S. registered ETFs increased to more than $2.5 trillion from $580 billion, according to the SEC. One industry observer projected that ETF assets will increase to at least $6.2 trillion by 2021. See CNBC, ETFs Expected to Nearly Triple in U.S. in Next Five Years. For additional discussion on ETFs, see An Overview of Exchange-Traded Funds (ETFs).

Market Outlook

The pace of new regulations and enforcement actions is likely to slow in the coming months or years, with the possibility that the SEC may propose new rules designed to reduce regulatory burdens. As the regulatory pendulum swings more toward a principles-based approach away from a rule-based regulatory approach, the role of fund directors will be as important as ever. Finally, market-based pressures may result in more investor assets flowing to index-based and actively managed ETFs, continuing the trend that began a decade ago.