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Core Principles for Financial Regulation

Tuesday, September 12, 2017
8:30 AM – 10:00 AM EDT

Morrison & Foerster LLP
250 West 55th Street
New York, NY 10019

Presenters:
Elaine Buckberg and Chris Laursen, The Brattle Group
Oliver Ireland and Anna Pinedo, Morrison & Foerster LLP

1. **The Brattle Group – Presentation**
2. **The Brattle Group – "Proposal to Remedy Horizontal Shareholding is Flawed"**
3. **The Brattle Group – "Target Date Funds: Economic, Regulatory, and Legal Trends"**
4. **The Brattle Group – "Securities Litigation Overview"**
5. **Morrison & Foerster LLP – Presentation**
6. **Morrison & Foerster LLP – "OCC Seeks Public Comment on Volcker Rule"**
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8. **Morrison & Foerster LLP – "CHOICE Act: Reform or Recalibration?"**
9. **Morrison & Foerster LLP – "U.S. Treasury Department Report on Core Principles for Regulating the United States Financial System"**
10. **Morrison & Foerster LLP – "U.S. House of Representatives Passes the Financial CHOICE Act of 2017"**
11. **Morrison & Foerster LLP – "Living with the DOL Fiduciary Rule: Be Prepared for the June 9 Implementation Date"**
12. **Morrison & Foerster LLP – "Summary of DOL Conflict Rule, BICE and Principal Transaction Exemption"**

Core Principles for Financial Regulation

PRESENTED BY

Elaine Buckberg
Chris Laursen

SEPTEMBER 12, 2017

THE Brattle GROUP

Agenda

1. Where are we on TBTF?
2. What are the economic growth implications of current policy?
3. How have capital requirements impacted growth?
4. How much stress testing do we need?
5. What is the real impact of the Volcker Rule?
6. FSOC and OFR Adjustments—dead on arrival?
7. The Fiduciary Duty Rule—can the horse be put back in the barn?

Where are we on Too Big to Fail?

Where are we on Too Big to Fail?

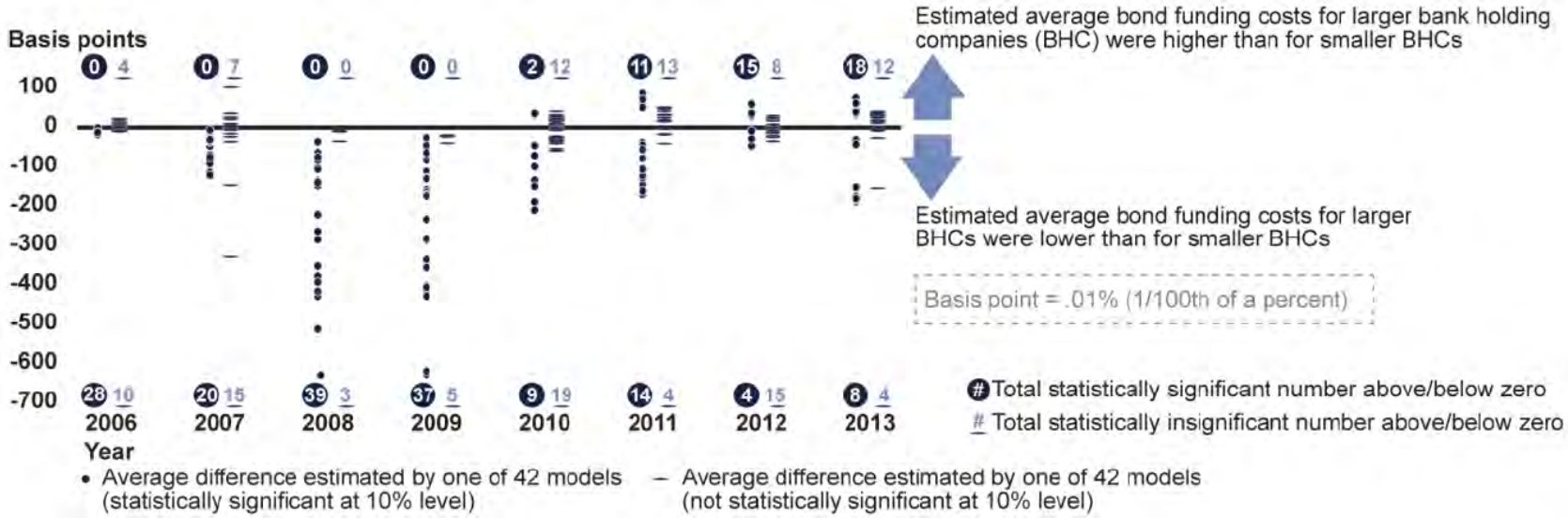
Research on the implicit subsidy for US banks considered too important to fail finds that the implicit subsidy for large BHCs peaked in 2009, then fell during the implementation of Dodd-Frank.

By end-2013, estimates were close to zero—some finding a small subsidy, others finding a small funding disadvantage.

US implicit subsidy came down farther and faster than European or Japanese banks, according to the IMF—clear testament to faster FinReg progress.

GAO: Implicit subsidy often negative in 2013

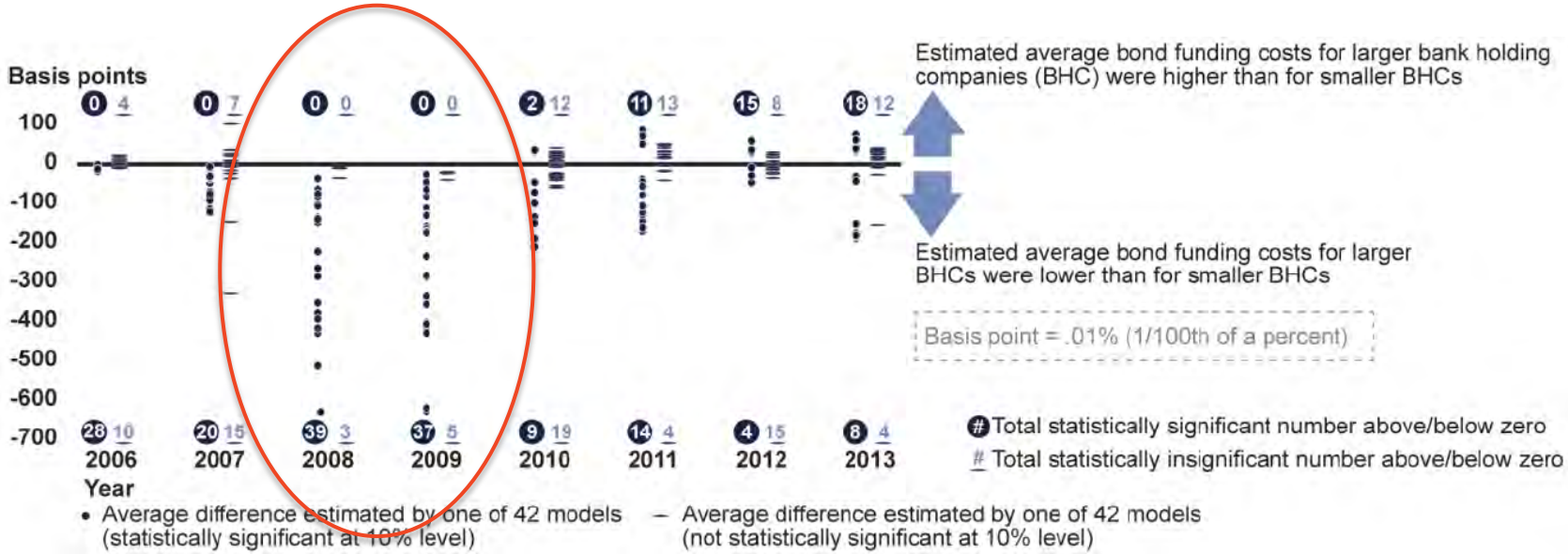
GAO estimated 42 models on bond yield spreads, annually.



Source: GAO analysis of data from Bloomberg and the Financial Stability Board. GAO-14-621

GAO: Implicit subsidy often negative in 2013

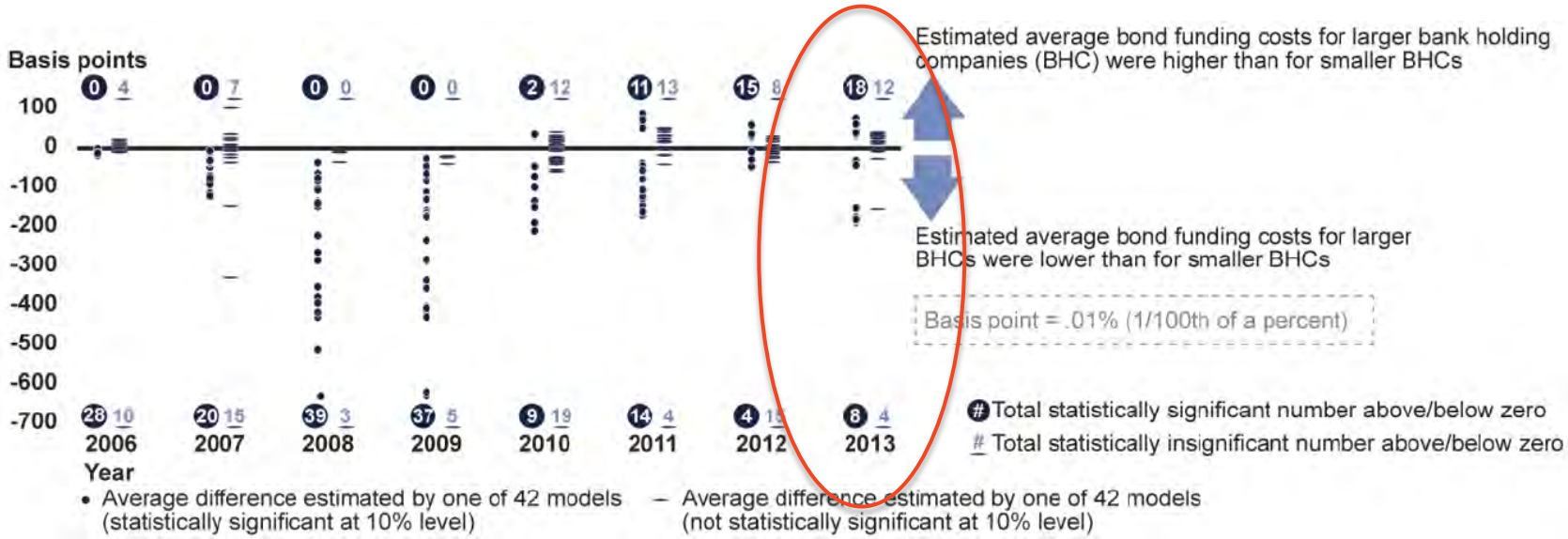
All 42 models found larger BHCs had lower funding costs than smaller ones in 2008 and 2009.



Source: GAO analysis of data from Bloomberg and the Financial Stability Board. GAO-14-621

GAO: Implicit subsidy often negative in 2013

In 2013, more than 2/3 of the models found a small funding cost *disadvantage* for the largest banks.



Source: GAO analysis of data from Bloomberg and the Financial Stability Board. GAO-14-621

What are the economic growth implications of current policy?

What are the economic growth implications of current policy?

Our fundamental goal in designing policies to prevent financial crises is to avoid the deep and prolonged recessions they bring.

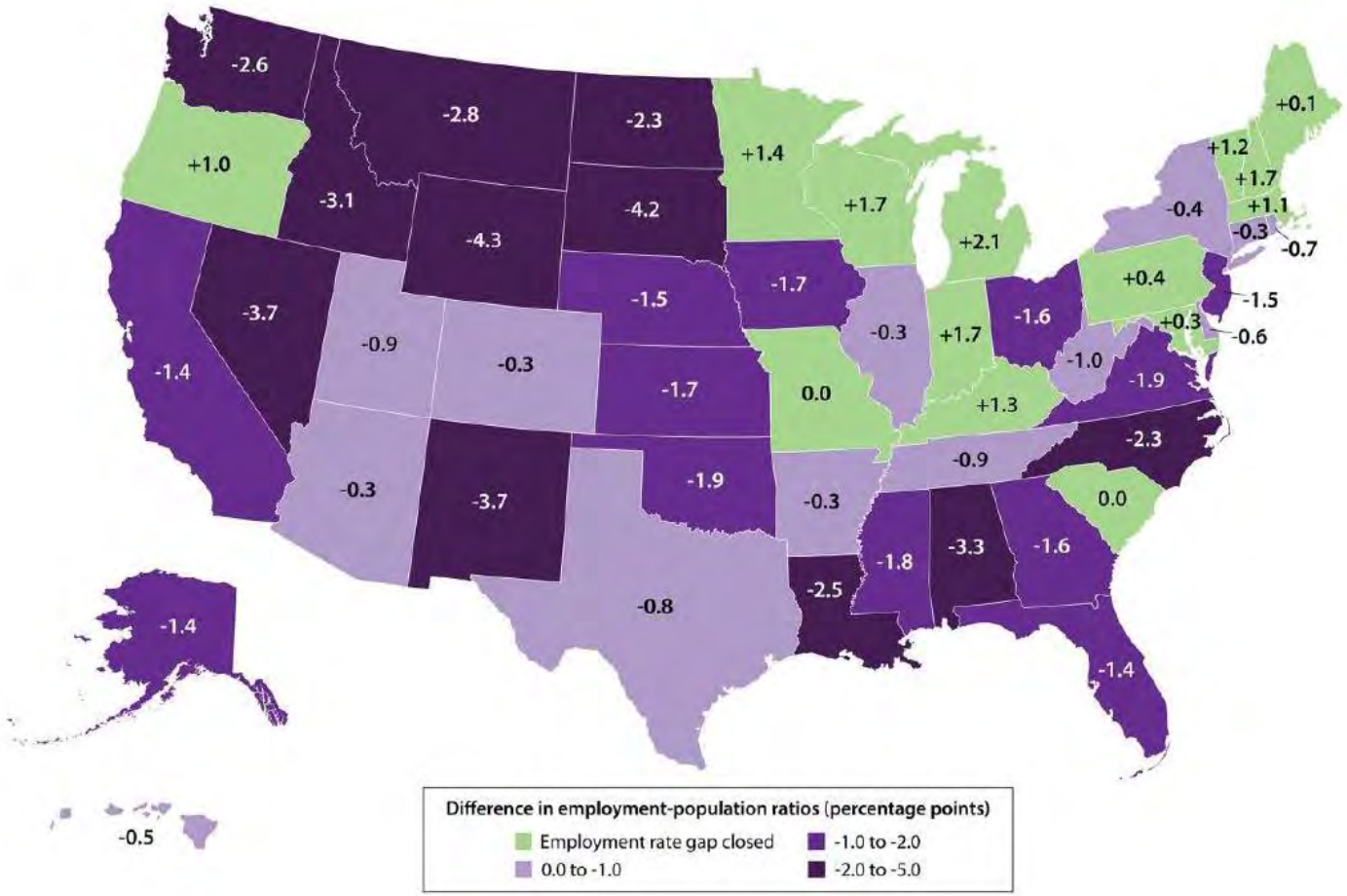
Ensuring the safety and soundness of our financial system helps prevent future Great Recessions and their extended aftermath.

A moderate reduction in lending that shaves a small amount of annual growth may be less costly than another Great Recession.

The jobs gap finally closed in July 2017

Source: The Hamilton Project, Brookings.

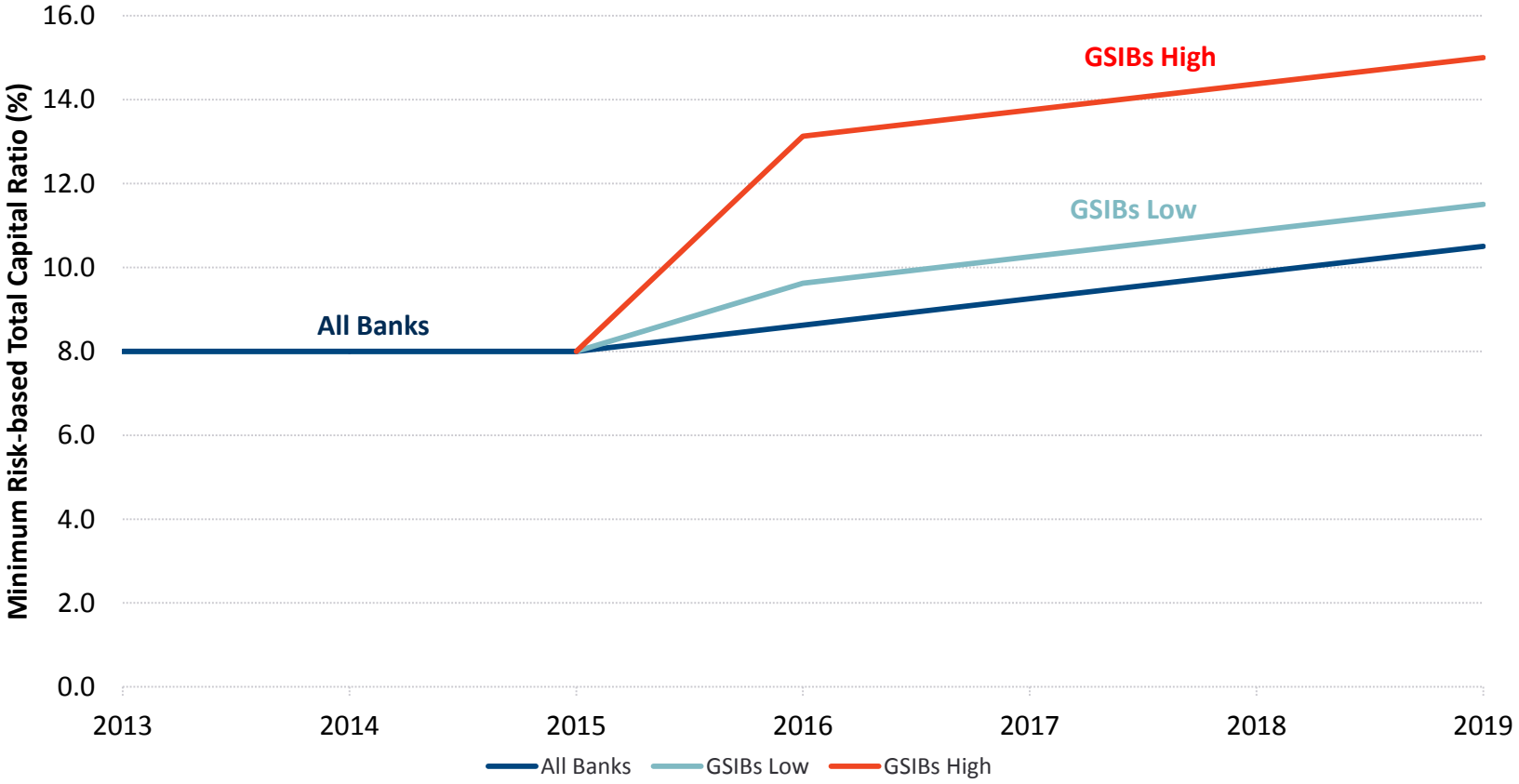
Many states face lingering employment gaps



Source: The Hamilton Project, Brookings.

How have capital requirements impacted growth?

U.S. Bank Capital Requirements – 2013-2019



Sources: Office of the Comptroller of the Currency, Congressional Research Service, Federal Deposit Insurance Corporation, Federal Register, PwC.

Research: Basel III posed little drag on growth

Global GDP impact of bringing bank capital up to 2019 Tier 1 Common Equity requirements is 3 bps/year.

Maximum impact is 0.22% after 35 quarters.

Macroeconomic Assessment Group established by FSB and BCBS, "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements," Final Report, December 2010

Because US relies heavily on capital markets vs. bank lending, GDP impact of a 100 bp rise in bank lending spreads will be smallest in US.

Effect of reaching 2019 Basel III requirements: 12 bps/year.

Patrick Slovik and Boris Cournède, "Macroeconomic Impact of Basel III", OECD Economics Department Working Paper No. 844, 14 February 2011

Would a 10% capital requirement boost economic growth?

How much stress testing do we need?

Why stress test?

We designed deposit insurance both to protect depositors and to prevent self-realizing bank runs.

Lehman and Bear were undermined by funding runs—
by creditors other than depositors.

Stress tests prevent large financial institutions from taking excessive risk
and
by making results public, help ensure creditor and public confidence in specific institutions and the financial system as a whole.

How low do you need to go?

U.S. Banks by Asset Tier

Assets	Number of Banks	% Total U.S. Bank Assets
> $250B	12	50.5%
$100B - $250B	18	15.6
$50B - $100B	14	6.0
$10B - $50B	79	10.3
< $10B	5,665	17.6

72%

Source: FDIC Bank Data and Statistics.
Notes:
Figures as of March 31, 2017.

What is the real impact of the Volcker Rule?

Volcker Rule: Proprietary Trading

Common Criticisms:

No One Knows What Proprietary Trading Means

- OCC and Federal Reserve officials

The Rule Hurts Market Liquidity

- NYFRB vs. Federal Reserve Board Research

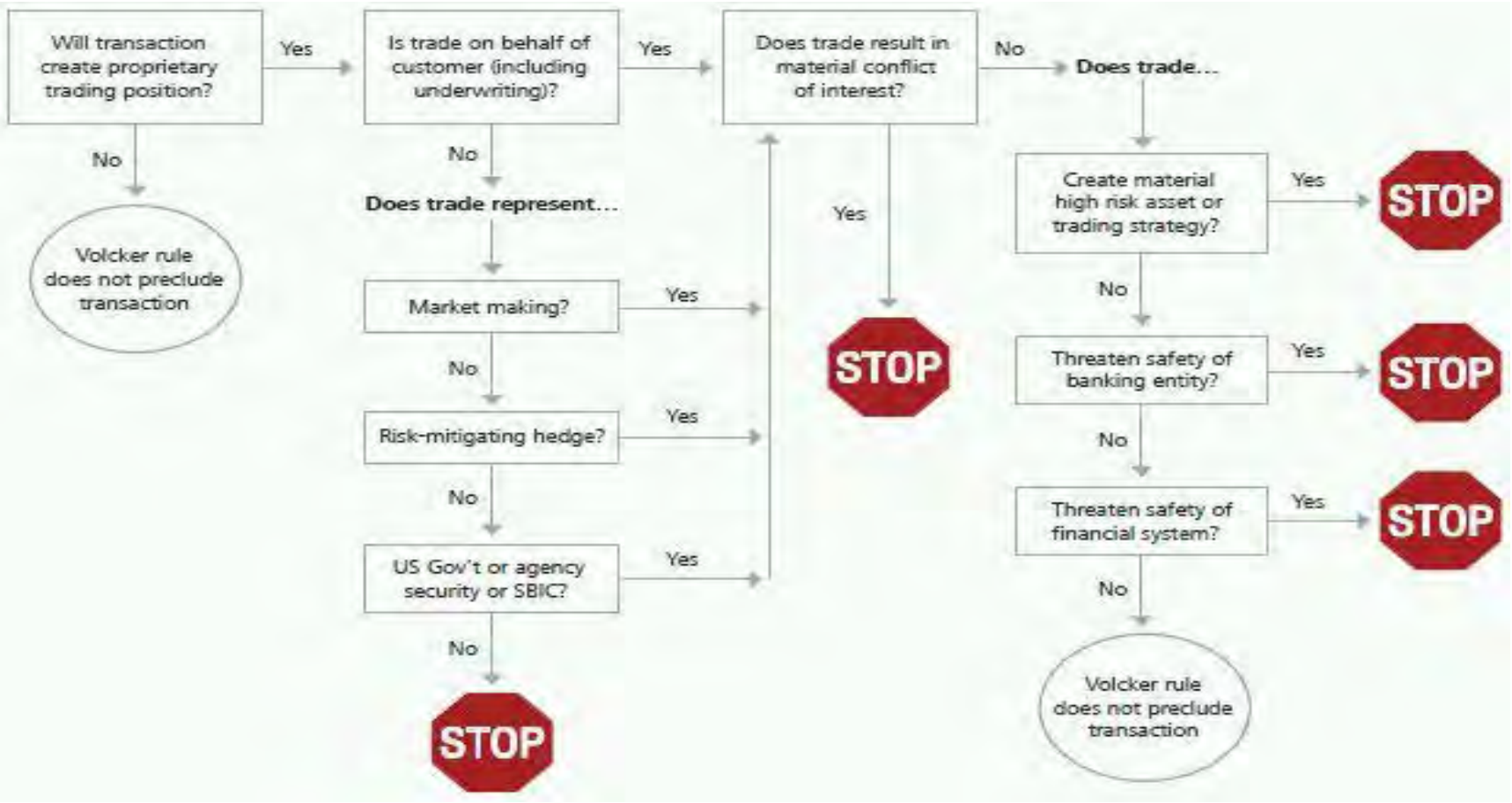
The Rule Creates Unnecessary Compliance Burden For Small Banks

- If a small bank trades

Too Many Regulators Charged With Enforcement

- Multiple “Legal Entity” and “Market” Regulators

Volcker Rule: Proprietary Trading Flowchart



Source: Christopher Laursen.

Volcker Rule: Covered Funds

Risks Associated With Covered Funds Recognized by Treasury

These restrictions are intended to eliminate banks' ability and incentive to bail out their funds in order to protect their reputational risk, guard against conflicts of interest with clients of the bank, and prevent banking entities from engaging in proprietary trading indirectly through funds.

Simplified Definition of Covered Fund Recommended

The current approach of defining covered funds by reference to whether they would be deemed investment companies under the Investment Company Act but for certain specific exemptions[106] requires banks to go through a highly technical, fact-specific legal analysis. Instead, regulators should adopt a simple definition that focuses on the characteristics of hedge funds and private equity funds with appropriate additional exemptions as needed.

Department of the Treasury, "A Financial System That Creates Economic Opportunities," June 2017

Volcker Rule: Questions on Impact

Is Repeal of Volcker Rule Important to Small Banks?

- The “rebuttable presumption” of trading

Do/Will Regulators Strictly Enforce Proprietary Trading Restrictions?

- Market Making Allowed: “reasonably expected near-term demand”
- Underwriting Allowed
- Non-Underwriting Block-Trades Allowed

Are Data Reporting Requirements Overly-Burdensome?

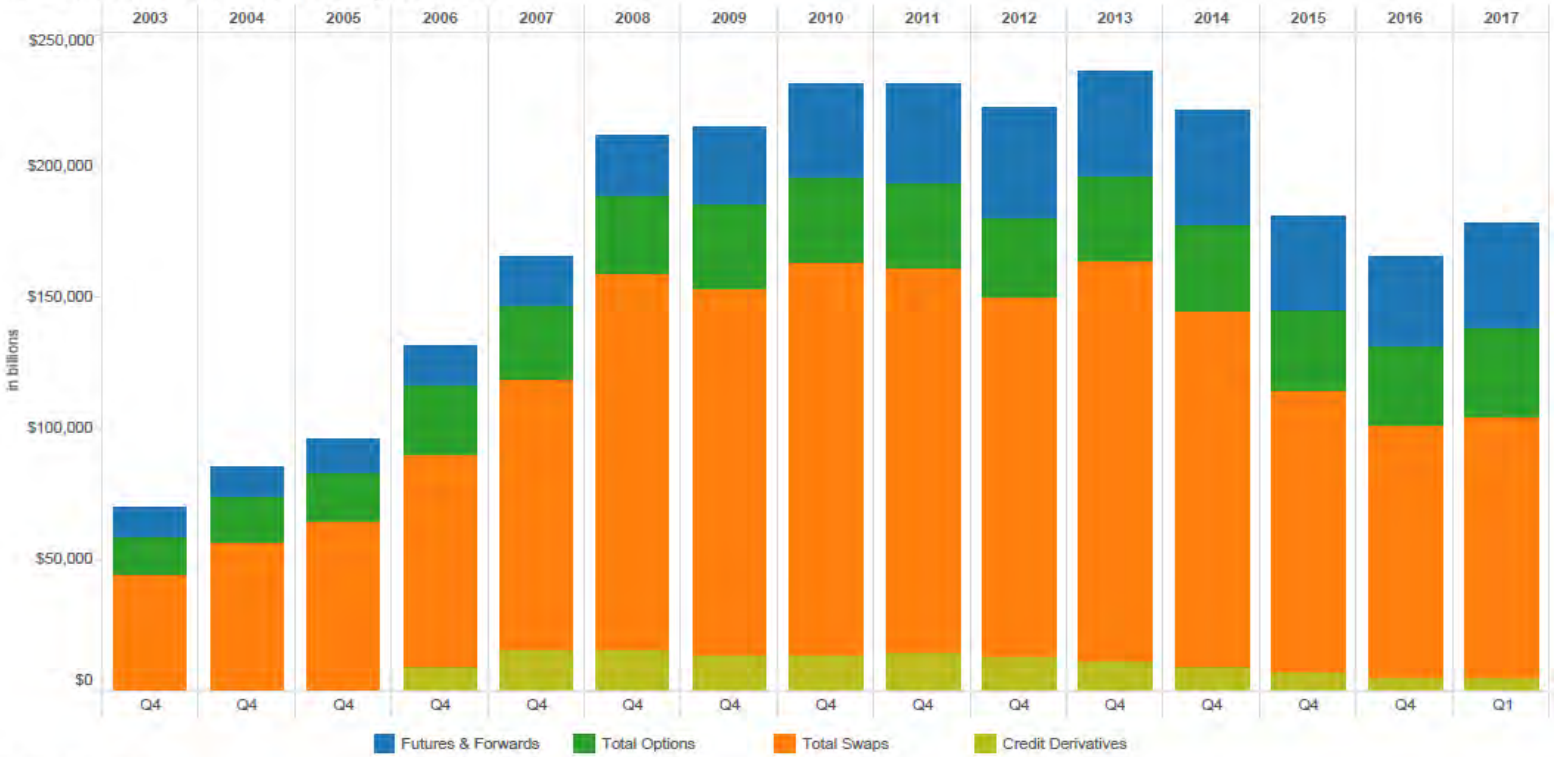
Impact of Volcker on Insured Bank Trading to Date?

Reduction in Bank Trading Assets

Source: Federal Reserve Bank of St. Louis.

Less Reduction in Bank Derivatives Exposure

Derivative Contracts by Product*
Insured U.S. Commercial Banks and Savings Associations

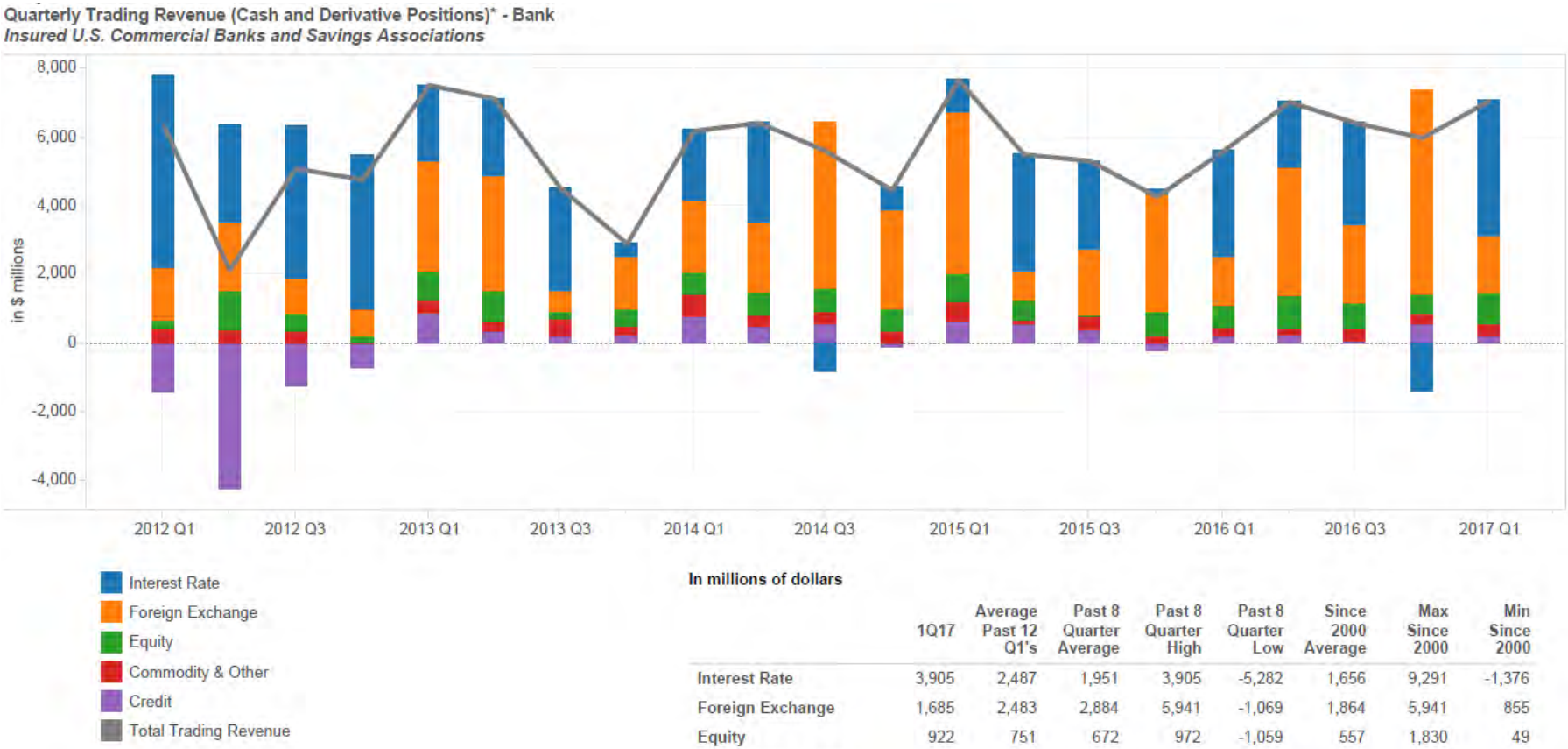


In billions of dollars

	2003 Q4	2004 Q4	2005 Q4	2006 Q4	2007 Q4	2008 Q4	2009 Q4	2010 Q4	2011 Q4	2012 Q4	2013 Q4	2014 Q4	2015 Q4	2016 Q4	2017 Q1
Futures & Forwards	$11,406	$11,370	$12,057	$14,882	$18,867	$22,529	$29,652	$35,539	$37,469	$41,621	$40,027	$43,380	$35,685	$34,193	$39,858
Total Options	14,616	17,754	18,858	26,277	27,727	29,747	31,884	32,078	32,505	30,375	32,305	33,081	30,889	29,386	33,999
Total Swaps	44,090	56,411	64,712	81,340	103,102	143,111	139,138	149,331	146,266	136,608	152,469	135,169	107,392	96,384	99,183
Credit Derivatives	0	0	0	9,020	15,863	16,029	14,112	14,151	14,759	13,190	11,191	9,449	6,986	5,293	5,304
Total Notional	70,112	85,536	95,627	131,519	165,559	211,416	214,786	231,099	230,998	221,794	235,992	221,078	180,952	165,256	178,343

Source: Office of the Comptroller of the Currency.

Bank Trading Revenue Levels Persist

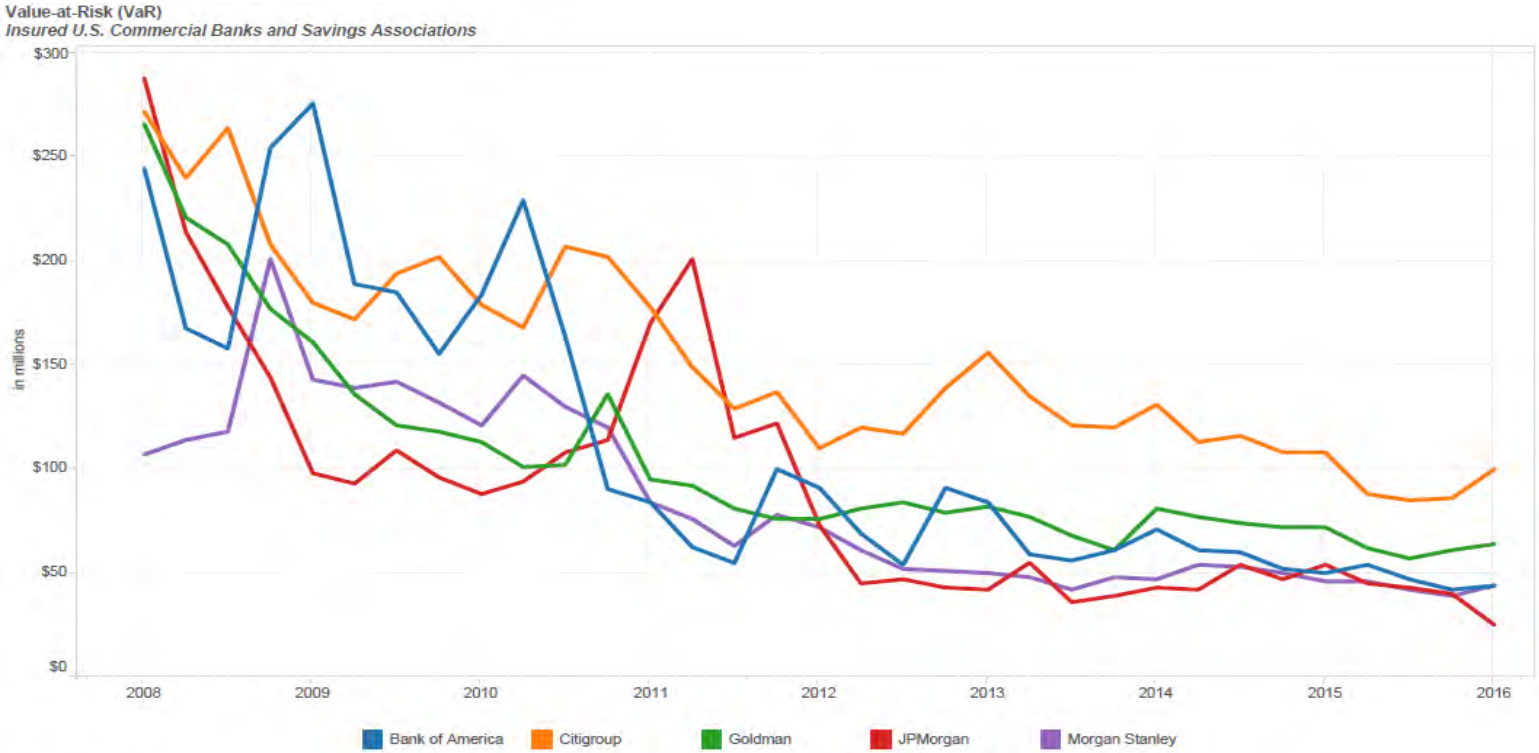


In millions of dollars

	1Q17	Average Past 12 Q1's	Past 8 Quarter Average	Past 8 Quarter High	Past 8 Quarter Low	Since 2000 Average	Max Since 2000	Min Since 2000
Interest Rate	3,905	2,487	1,951	3,905	-5,282	1,656	9,291	-1,376
Foreign Exchange	1,685	2,483	2,884	5,941	-1,069	1,864	5,941	855
Equity	922	751	672	972	-1,059	557	1,830	49
Commodity & Other	328	464	303	587	-307	226	789	129
Credit	223	447	287	624	-10,237	-191	2,727	-222
Total Trading Revenue	7,062	6,633	6,097	7,669	-10,580	4,112	10,217	4,273

Source: Office of the Comptroller of the Currency.

Bank Reported Value-at-Risk Exposure Falling



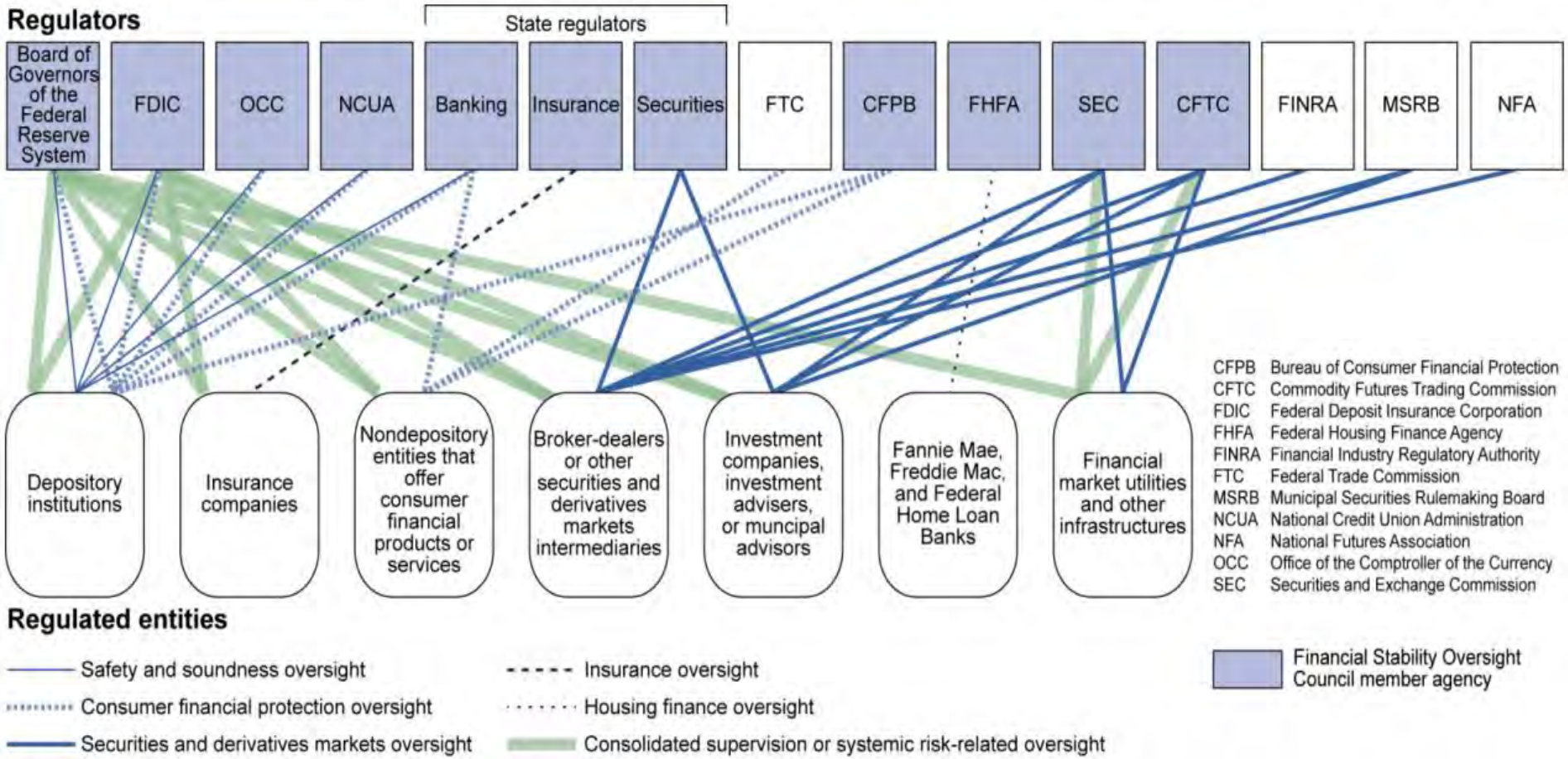
In millions of dollars

	2011				2012				2013				2014				2015				2016				2017
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Bank of America	$184	$229	$164	$90	$84	$63	$55	$100	$91	$69	$54	$91	$84	$59	$56	$61	$71	$61	$60	$52	$50	$54	$47	$42	$44
Citigroup	179	168	207	202	178	149	129	137	110	120	117	139	156	135	121	120	131	113	116	108	108	88	85	86	100
Goldman	113	101	102	136	95	92	81	76	76	81	84	79	82	77	68	61	81	77	74	72	72	62	57	61	64
JPMorgan	88	94	108	114	170	201	115	122	73	45	47	43	42	55	36	39	43	42	54	47	54	45	43	40	25
Morgan Stanley	121	145	130	120	84	76	63	78	72	61	52	51	50	48	42	48	47	54	53	50	46	46	42	39	44
Total	685	737	711	662	611	581	443	513	422	376	354	403	414	374	323	329	373	347	357	329	330	295	274	268	277

Source: Office of the Comptroller of the Currency.

FSOC and OFR adjustments—dead on arrival?

U.S. Financial Regulatory Structure



Source: GAO. GAO-16-175.

Treasury Recommends Increased Accountability… to the Executive Branch

President or Appointed Board to Fire Regulators

Opportunities for Reform

Treasury recommends that Congress take action to reduce fragmentation, overlap, and duplication in financial regulation. This could include consolidating regulators with similar missions and more clearly defining regulatory mandates. Increased accountability for all regulators should be achieved through oversight by an appointed board or commission, or in the case of a director-led agency, appropriate control and oversight by the Executive Branch, including the right of removal at will by the President.

OFR – Loss of Independence to Treasury

The Office of Financial Research was created by Dodd-Frank, in part, as an independent resource to support the FSOC and its members in advancing the FSOC's financial stability mission. Congress should reform the structure and mission of the Office of Financial Research to improve its effectiveness and to ensure greater accountability. As part of this assessment, Treasury recommends that the OFR become a functional part of Treasury, with its Director appointed by the Secretary, without a fixed term and subject to removal at will, and that the budget of OFR come under the control of the Treasury appropriation and budget process.

Department of the Treasury, "A Financial System That Creates Economic Opportunities," June 2017

FSOC: Designation of Primary Regulator

The statutory mandate of the FSOC should be broadened so that it can assign a lead regulator as primary regulator on issues where multiple agencies may have conflicting and overlapping regulatory jurisdiction. This new authority would allow the FSOC to play a larger role in the coordination and direction of regulatory and supervisory policies. The FSOC should also be reformed to further facilitate information sharing and coordination among the member agencies regarding financial services policy, rulemaking, examinations, reporting, and enforcement.

Which Regulators Will Surrender Turf to a Designated Primary Regulator?

What Would be the Incentives of Non-Primary Regulator?

The Fiduciary Duty Rule – can the horse be put back in the barn?

Retirement savings have changed since 1974

	Assets ($ billions)	Total Participants/ Households (millions)
	[1]	[2]
IRAs	8.2	42.5
Defined Contribution inc. 401(k)	7.3	94.7
Defined Benefit	8.5	37.7
Total	**24.0**	**174.9**

Sources: Employee Benefit Research Institute, Investment Company Institute.
Notes:
[1]: Asset figures as of 2017 Q1.
[2]: Figure for IRAs is the number of U.S. households with any type of IRA in 2016, including households with more than one type. Figures for Defined Contribution and Defined Benefit are from Form 5500 filings for plan years ending in 2014.

Conflicted advice is expensive

"The Department estimates that the final rule and exemptions, by mitigating this particular type of adviser conflict, will produce gains to IRA investors worth between $33 billion and $36 billion over 10 years and between $66 and $76 billion over 20 years."

Department of Labor, "Regulating Advice Markets," April 2016

U. Oregon pension plan participants using brokers had lower returns than default fund

Defined contribution plan participants electing to use brokers placed high value on face-to-face interactions with their provider.

Over 1999-2009, broker clients earned an average annual return, net of fees, of 1.8%.

The same clients would have earned 4.8% in target date funds (160% more) and had lower market risk.

Brokers earned 0.90%, taking 1/3 of the gross return.

John Chalmers and Jonathan Reuter, "What is the Impact of Financial Advisors on Retirement Portfolio Choice and Outcomes?" Journal of Public Economics (Forthcoming)

Disclaimer

The views expressed in this presentation are strictly those of the presenter and do not necessarily state or reflect the views of The Brattle Group.

Presenter Information

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Dr. Elaine Buckberg is an economist with over 20 years of consulting, policy, and expert witness experience. She provides consulting services and testimony in litigation and regulatory disputes in finance, complex commercial litigation, and bankruptcy and advises parties in public-private partnerships for infrastructure investment. Her experience spans civil, regulatory, and criminal issues in the United States and Europe and includes testimony in federal and state court and in arbitrations. Dr. Buckberg has assisted clients in responding to regulatory rulemakings and consulted on regulatory and internal investigations. Her recent expert and consulting work has focused on hedge funds, valuation of complex derivatives, securities class actions, and foreign exchange trading.

Prior to joining The Brattle Group, Dr. Buckberg served as deputy assistant secretary for policy coordination at the U.S. Treasury Department's Office of Economic Policy. In this role, she advised the Treasury Secretary and senior staff on policy issues including financial regulatory reform, housing finance, infrastructure, anti-money laundering (AML), virtual currency, and economic policy options for Puerto Rico. Dr. Buckberg led teams in the development and economic analysis of the qualified financial contract, fiduciary duty, and customer due diligence rules. She also played a major role in initiating and executing President Obama's Build America Investment Initiative on infrastructure, including authoring two white papers on public-private partnerships.

Before her government service, Dr. Buckberg was a senior vice president at NERA Economic Consulting, a vice president at Morgan Stanley, an economist at the International Monetary Fund, and a lecturer at Georgetown University School of Business. She holds a Ph.D. in Economics from MIT and an undergraduate degree from Yale University. Dr. Buckberg is fluent in Spanish and French.

Presenter Information

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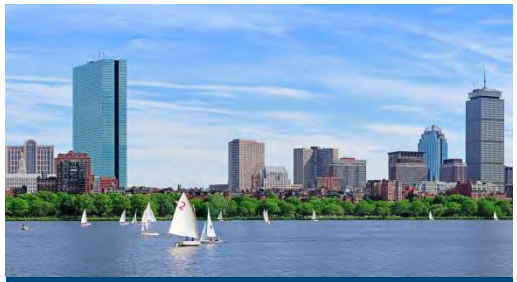
Christopher Laursen is an expert in financial products, institutions, markets, regulation, and risk management. He has more than 25 years of financial industry experience, which includes over 17 years as a Federal regulator, where he served as a policy-maker, supervisor, and senior examiner.

Mr. Laursen provides expert testimony and analysis as well as consulting services for public and private clients. He has testified in disputes involving investment and trading strategies, mortgage-backed securities, municipal finance, structured notes, financial institution accounting, and insider trading. He has consulted for the DOJ, SEC, and the Financial Crisis Inquiry Commission.

Mr. Laursen previously served as the Federal Reserve Board's Manager of Risk Policy and Guidance, where he wrote and interpreted financial regulations and guidance. He also worked closely with other U.S. and international financial regulators to craft new rules, including as a member of the Basel Committee's Trading Book Group. During the financial crisis, Mr. Laursen led reviews of problem institutions and assisted in the development of special FRB actions to reduce market turmoil and economic damage.

Mr. Laursen holds an MBA with a concentration in finance from the Wharton School is a FINRA Certified Regulatory and Compliance Professional.

Offices



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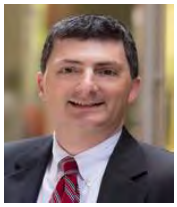
Proposal To Remedy Horizontal Shareholding Is Flawed

By **Elaine Buckberg, Steven Herscovici, Branko Jovanovic and James Reitzes**

Law360, New York (July 17, 2017, 11:37 AM EDT) --

Several recent studies claim to show that competition is adversely affected when institutional investors hold significant shares in multiple firms within a "concentrated" industry, leading to higher prices and other effects.[1] Following on this research, Eric Posner, Fiona Scott Morton and E. Glen Weyl have proposed a remedy that would allow institutional investors to hold shares in only one company in a concentrated industry, or to limit their shareholdings to no more than a 1 percent total equity stake in the industry when holding shares in multiple companies. They also propose a "safe harbor" for stand-alone "purely passive" index funds that commit both to having no contact with management of companies whose shares they own, and to voting their proxies in proportion to other shareholders' votes.

Elaine Buckberg



Steven Herscovici

Branko Jovanovic

James Reitzes

We believe that the empirical literature cited by Posner et al. in support of competitive harm from horizontal shareholding is far from definitive and suffers from potential flaws. As such, there are doubts whether horizontal shareholding creates a competitive problem that justifies invoking a particular blanket "remedy," as opposed to a case-by-case analysis and more selective remediation. Analysis of the costs of the proposed blanket solution, which may be substantial (as we detail below), is lacking.

Posner et al. argue that their proposed remedy would increase competition, while not adversely affecting the public, because it would still allow investors to hold mutual funds that are diversified across industries (as opposed to within an industry) or achieve full diversification via purely passive index funds. Their analysis of the proposal's cost underestimates the disruption it is likely to create for investors and financial markets.

As explained below, the proposed rule would place increased burdens on investors, financial advisers and intermediaries (who would have to reconstruct portfolios and fund platforms based on proposed limitations imposed on investment advisers), raise transactions costs (as investment advisers sell assets and investors sell fund shares in response to the limitations), and possibly force funds to hold more short-term assets (e.g., when switching equity holdings between companies in a concentrated industry).

Good public policy requires carefully considering how a proposal may affect stakeholders. The proposed rule would have important, adverse consequences for many households' ability to accomplish their long-term financial goals, such as saving for

retirement, education, homeownership or other purposes. As such, the proposal would go against a number of bipartisan public policy objectives.

The Proposed Remedies Lack Adequate Definition

Posner and co-authors may be proposing a solution to a problem that does not exist. But they propose to solve it by promulgating a simple rule: In any concentrated industry, an "investor" may be allowed to hold either (1) a total industry ownership stake no larger than 1 percent, or (2) shares in only a single effective firm.[2] As noted above, purely passive index funds would be exempt.[3]

Key implementation questions are unanswered. The paper fails to define "investor" with enough precision to know which entities are covered by the rule. As a practical matter, any definition will be determined by government agencies and heavily litigated in courts. Will the 1 percent limit be applied to all holdings managed by an asset management complex, or only those where the firm has the right to vote the shares? Will separately managed accounts for institutional investors (e.g., pension funds) count against the limit?

The paper fails to establish workable criteria for identifying industries covered by the rule. Posner et al. propose that the U.S. Department of Justice and the Federal Trade Commission would annually compile a list of industries to be designated as "oligopolies," along with company market shares within those industries.[4] Posner et al. do not answer questions critical to determining how fund managers would be restricted: How would "concentrated industries" be defined, and how would the companies in them be identified?[5] What is the relationship between the identification of concentrated industries and the traditional antitrust identification of relevant markets, which is used to assess the potential competitive effects of mergers and acquisitions and "monopolizing" firm practices alleged to preserve or enhance market power?

If certain industries (e.g., airlines) are determined to be concentrated, identifying competitors might not be too difficult. However, in other industries, determining which firms are horizontal competitors may be more difficult. For example, Apple and PayPal both offer e-payment services. Do they compete in the technology industry? In the financial services industry with Visa and MasterCard? If so, do they also compete with JPMorgan Chase and other credit card issuers? For the purposes of meeting the thresholds, would the market be defined solely in terms of U.S. companies, or would foreign competitors also be included?

The DOJ and FTC frequently collect and analyze significant amounts of data in defining relevant markets in merger cases. Requiring the antitrust authorities to do so for potentially relevant markets where horizontal shareholding may pose no significant anti-competitive issues would be a poor use of the agencies' limited resources.

The Disruptions That the Proposal Would Cause to Asset Managers Would Harm Customers

The 1 percent threshold would have a profound impact on investors and the equity markets. Investors benefit from the broad offerings of mutual fund complexes in several ways. For example, investors can assemble a broadly diversified portfolio consisting of complementary funds within a single fund complex. Many fund complexes have broad offerings from which investors can compose a portfolio of active funds, index funds or a combination. Under the proposed rule, fund complexes would be able to offer only purely passive index funds or active funds, not both, unless the holdings of the entire fund complex remained under the 1 percent threshold.[6]

Ultimately, the proposed rule would reduce active managers' discretion and nimbleness. Under the proposed rule, a fund complex would have to choose whether to invest in a single firm in any industry deemed to be concentrated, or remain under the 1 percent threshold. Larger fund complexes would constrain individual fund managers to invest in only a single firm in an industry — and that industry would be chosen at the complex level, not chosen by the specific fund manager.

This restriction limits the ability of a fund complex to offer investors diversified industry exposure, either as a way of managing volatility or expressing a view that a particular industry is likely to outperform the market generally. This limitation is particularly problematic in that it would apply to the holdings of all funds across all investment objectives. Complexes would need to develop centralized approaches to selecting stocks in concentrated industries to ensure compliance with the threshold. This would stand in stark contrast to the asset management industry's current practice of granting a portfolio manager broad discretion to manage a fund independently, consistent with the fund's prospectus.

In particular, such centralized stock selection for concentrated industries would reduce the ability of fund complexes to offer a broad range of funds with different mandates. Consider the credit card industry. At one fund complex, several growth funds hold Visa among their top 10 holdings, whereas a value fund within the same complex counts Discover as one of its top 10 holdings. Under the Posner et al. proposal, the fund complex would be forced to either hold only one of Visa or Discover, or reduce its combined holdings of the industry below the 1 percent threshold. Similarly, suppose that a fund manager believes the biotech industry is underpriced and would like to invest in a diverse portfolio of the companies in this industry. In order to conform to the 1 percent limit, the fund managers would be forced to invest in only one company.

The Proposal Also Would Cause Market Disruptions That Would Harm Investors

The proposal could disrupt markets to the detriment of funds and other investors. Fund traders take care to minimize the price impact of their trades by gradually moving into and out of positions without allowing other market participants to learn of their trading intentions. Consequently, mutual funds often buy or sell shares over an extended period of time. If an asset manager decides to change its chosen stock in a concentrated industry, the total size of the positions the fund or complex is selling and acquiring may affect market prices for those companies, impairing investor returns.

As a practical result, the rule would make it nearly impossible for large asset managers to change which firm they hold in a concentrated industry while still offering their clients consistent market exposure over time. During the time the fund complex takes to unwind the existing position and subsequently build its position in the preferred company, all affected funds would have to hold more cash and have less exposure to the industry in question than they otherwise would choose.

Costs of Breaking Up Asset Managers

Fund families would have to either significantly reduce their assets under management to avoid exceeding the 1 percent threshold — or develop a business model that enables them to hold a stake in only a single effective firm. Any fund complex wanting to offer a diversified set of funds to investors would be forced to remain small enough that its total holdings in any concentrated industry would not reach the 1 percent threshold. Effectively, this would force large active asset managers to break up.

Asset managers might attempt to comply with the 1 percent threshold in a number of ways. Some may

offer a limited but diversified set of mutual funds; others may choose to offer a single fund at a larger scale.

Changing the mutual fund landscape, however, would be costly for investors and companies running 401(k) plans, both in the transition and over time. Consumers directing their own individual retirement account, Roth IRA, 529 plan or other accounts may have to spread investments across multiple fund complexes to gain full diversification.

Some consumers' portfolios would be less well-managed as a result, either less diversified or less frequently rebalanced, if at all. Rebalancing across fund families would be more time-consuming, likely making many consumers rebalance less frequently, if at all. Similarly, 401(k) plans would need to reconsider their menu of fund options in light of changing fund complex offerings and changing fees.

Alternative Approaches May Be Less Disruptive

Even if further peer-reviewed research ultimately points to anti-competitive effects from common ownership in certain industries,[7] it will be important for policymakers to remedy the anti-competitive effects while minimizing the restrictions placed on fund complexes. For example, Edward B. Rock and Daniel L. Rubinfeld propose creating a safe harbor for investors with stakes smaller than 15 percent, no board representation, and "normal" corporate governance activities focused on best practices such as board composition and governance, transparency and executive compensation. Rock and Rubinfeld argue that this approach would match the Hart-Scott-Rodino "solely for investment" standard which applies if the investor "has no intention of participating in the formulation, determination, or direction of the basic business decisions of the issuer."[8]

Although the full impact of the Rock and Rubinfeld "solely for investment" proposal would need to be fully analyzed, it appears to have two important advantages over the Posner et al. approach: asset managers could maintain industry exposure without being forced to pick a single winner in each concentrated industry and they could avoid disruptions associated with changing holdings or approaching a threshold. Allowing institutional investors to continue contributing to basic corporate governance would also benefit consumers and shareholders.[9]

Conclusion

Posner et al. propose a costly and disruptive way to change asset manager behavior that would impair households' ability to accomplish their long-term financial goals — despite the weak evidence that institutional cross-holdings may be a source of anti-competitive behavior. More research on whether institutional holdings are related to reduced competition is needed first. Even if that proves out, the goal of any remedy should be to mitigate anti-competitive behavior while minimizing the costs associated with achieving efficiency-enhancing investment objectives. We believe the remedy, as proposed, does not do so.

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[1] Jose Azar, Martin Schmalz and Isabel Tecu, "Anti-Competitive Effects of Common Ownership," Working Paper, March 2017; see also Jose Azar, Sahil Raina, Martin Schmalz, "Ultimate Ownership and Bank Competition," Working Paper, July 2016. The findings of Azar et al. are hardly conclusive, however. O'Brien and Waehrer argue that Azar et al. have identified only correlations between prices and measures of concentration modified to take into account the effects of common ownership, and that these correlations "have no clear implication for the effects of common ownership on prices and do not form a reasonable basis for policy, let alone the major changes in policy that some have proposed." See Daniel P. O'Brien and Keith Waehrer, "The Competitive Effects of Common Ownership: We Know Less Than We Think," Working Paper, February 2017, p. 6. Furthermore, Novick et al., argue that "some of the economic papers use data filed for the purposes of regulatory reporting of shareholdings under various national security laws to identify common owners of companies. This data is, however, fundamentally unsuitable for identifying economic ownership, as asset managers are not the owners of the assets they manage, but rather act as agents on behalf of multiple clients." See Barbara Novick, Michelle Edkins, Gerald Garvey, Ananth Madhavan, Sarah Matthews and Jasmin Sethi, "Index Investing and Common Ownership Theories," BlackRock Viewpoint, March 2017, p. 7,

[2] The authors define an effective firm as either a single firm, or alternatively a stake in multiple firms that have a combined market share less than the "average size" firm in the industry (which they define as Industry HHI/10,000). Posner et al., p. 34.

[3] Going forward, we use "investment funds," "mutual funds," "fund complexes" and "asset managers" to refer to all funds other than purely passive index funds and the firms that manage them; similarly, "investors" refers to investors in any nonpurely passive fund.

[4] Posner et al., p. 34.

[5] Rock and Rubinfeld point to another unanswered question in an earlier draft of Posner et al.: "How does one characterize multiproduct firms? ... Which are the firms that they must choose from and who will decide? How will foreign firms be treated?" See Edward B. Rock and Daniel L. Rubinfeld, "Defusing the Antitrust Threat to Institutional Investor Involvement in Corporate Governance," Working Paper, March 2017, p. 25.

[6] Novick et al. argue that proposed policy changes "would significantly inhibit the strategies of pension funds, institutional accounts, retirement plans and individual accounts, which use asset managers' services to help deliver their long-term investment objectives. They would also flout principles of diversification encouraged in regulations, which have long recognized index investing as a valid means of diversifying at a low cost." See Novick et al. (2017), page 13.

[7] In recent papers, Vives and Woodbury emphasize the need for further research. Vives observes that "it is still early to advance and implement major changes in regulation and antitrust enforcement. Before that we need to have a better understanding of the channels of transmission of ownership patterns into competitive outcomes, via corporate governance" and that "more empirical evidence of consumer harm and the effects on innovation." Xavier Vives, "Institutional Investment, Common Ownership and Antitrust," CPI Antitrust Chronicles Volume 1, No.3 (2017), available at https://www.competitionpolicyinternational.com/institutional-investment-common-ownership-and-antitrust, p. 3 Similarly, Woodbury states that "There should be little doubt that further research should

be pursued by these and other researchers to validate (or not) the anticompetitive effect and the generality of that effect of shareholdings by institutional investors. If that effect is robust, it could justify significant changes in policy. But it would be premature and potentially very costly to do so without that further evidence." John Woodburry, "Can Institutional Investors Soften Downstream Product Market Competition," CPI Antitrust Chronicles Volume 1, No.3 (2017), available at https://www.competitionpolicyinternational.com/can-institutional-investors-soften-downstream-product-market-competition, p. 9.

[8] See Rock and Rubinfeld (2017), p. 33.

[9] However, as Patel (2017) points out, "there is insufficient economic theory or empirical analysis to know with reasonable certainty where the necessary lines should be drawn." Patel also recognizes that "there is some intuitive appeal to establishing an antitrust safe harbor or a presumption of insubstantial competitive effects for common ownership amounts not exceeding a set threshold in a given relevant market." Menesh Patel, "Common Ownership, Institutional Investors, and Antitrust," Working Paper (2017), p. 62.

TARGET DATE FUNDS
Economic, Regulatory, and Legal Trends

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DRAFT
September 2017

THE Brattle GROUP

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Target Date Funds (TDFs), which presently account for over $1 trillion dollars in assets, have experienced significant growth over the past decade, and are becoming an increasingly important part of the retirement investment universe.

These funds are often thought of as holding a mix of debt and equity investments, with the equity proportion declining over time following a predetermined glide path. In reality, current TDFs are far more complex. New regulations, including the recent Department of Labor's (DOL) Fiduciary Rule, are creating uncertainties for TDFs going forward. Given these dynamics and the sheer size of the TDF market, the current docket of TDF-related litigation is likely to grow.

In this series of whitepapers, The Brattle Group reports on key economic, regulatory, and legal issues and trends related to TDFs. In this first paper, we provide background on TDFs, reporting on significant market trends, and summarizing recent litigation.

I. WHAT IS A TARGET DATE FUND?

In most cases, a TDF is a fund of funds—used primarily for retirement wealth management.[1] TDFs are often touted as providing a "one-stop" or a "set it and forget it" retirement portfolio solution as they are designed to dynamically allocate across a variety of investment classes based on designated target retirement dates. Professional investment managers of TDFs who allocate and re-allocate assets over time into various investment classes (e.g., equities, bonds, various funds) may be viewed as replacing the investment allocation/diversification decisions (or non-decisions) of individual investors or paid advisors.

The standard naming convention for an individual TDF includes the target retirement year as part of a fund's name. For example, the "Vanguard 2035 Fund Investor Shares" or the "Fidelity Freedom 2030 Fund" explicitly state their target years within their names. Large fund management companies typically offer TDF families with individual TDFs spaced into 5-year increments. Investors are generally expected to choose a TDF with a year closest to their targeted retirement.[2] "Lifecycle" or "age-based" funds are generally synonymous with TDFs.

Most TDFs exist in the form of open-end mutual funds, though TDF portfolios are also employed without a mutual fund wrapper in pooled investment vehicles such as Collective Investment Trusts (CITs). TDFs are currently available as an option in the majority of employer 401(k) plan offerings as well as other employee-sponsored defined contribution (DC) plans. According to Vanguard, approximately 90% of the DC plan sponsors it works with offered TDFs to their constituents at year-end 2015.[3] TDFs are also widely held within Individual Retirement Arrangements (IRAs)[4] and are available for purchase in non-tax-advantaged investment accounts.

At its core, a TDF's portfolio composition is set and adjusted by a fund manager primarily based on one key factor: the target date.[5] Almost universally, TDFs are designed to re-allocate into more conservative portfolios as the target date is approached and is passed.[6] Generally, fund managers' efforts to reduce risk over time are operationalized through a reduction in the portion of equity investments held in a TDF portfolio, as explained later.

Because TDF professional managers make investment allocation decisions meant to be generally appropriate for a cohort of investors with the same approximate target retirement date, a single TDF may be viewed as an alternative to:

- DC investment allocations selected by employees with no paid professional guidance;
- DC investment allocations selected by employees with paid professional guidance from a financial adviser/planner or robo-adviser;[7]
- IRA investment allocations selected with no paid professional guidance;
- IRA investment allocations selected with recommendations or paid professional guidance from a Registered Representative (RR) of a broker-dealer or a Representative of a Registered Investment Advisor (RIA), respectively; and
- Investment allocations selected with or without paid professional guidance in non-tax-advantaged investment accounts.

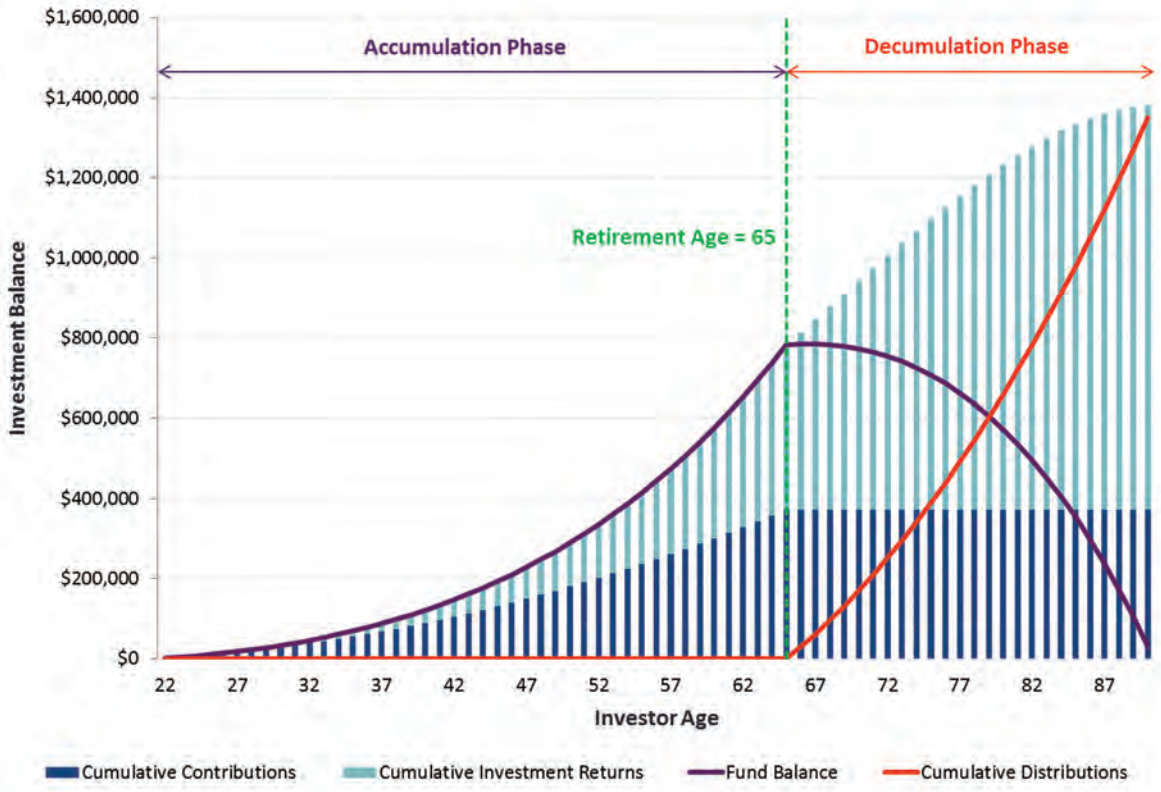
Though many discuss TDFs as an efficient way for retirement investors to obtain professional management of their retirement savings, others point out that a TDF may not be the best match for an individual's unique circumstances, particularly with off-the-shelf TDFs,[8] where the target date is often the only investor-specific parameter considered by the fund manager. In an effort to go beyond managing solely to a target date, some fund administrators offer employees one or more custom TDFs in an effort to provide alternative investment options that may align more closely with individual employee attributes and/or preferences. The asset management areas of many large financial institutions offer services that assist employee fund administrators with more custom TDF offerings. Of course, even these more tailored programs cannot be designed for the specific preferences of every eligible individual investor.

II. ACCUMULATION AND DECUMULATION PHASES OF RETIREMENT ASSETS

In retirement planning, the period of time beginning from when an individual starts working and saving for retirement up until the retirement date is termed the "accumulation phase." In this period, an individual accumulates wealth in investments that can be relied upon after employment income ceases. Conversely, during the "decumulation phase," those accumulated investments can provide retirement income through periodic income paid directly by the investments as well as conversion of the investments into cash (through sale/liquidation).

Figure 1 below provides a stylized illustration representing an employee who accumulates retirement funds from the age of 22 through the age of 64 and withdraws, or decumulates, those funds from the age of 65 through the age of 90. The gray colored "fund balance" line shows the investment balance growing until the retirement age and then declining until age 90 when it is fully depleted.[9]

FIGURE 1 Accumulation and Decumulation ($)



An investor can generally control his/her retirement date and thus the length of the accumulation phase.[10] However, the length of an investor's decumulation phase, as well as withdrawal preferences, depend on numerous factors specific to an individual, some of which are unknown. Clearly, cohorts of TDF investors with the same targeted retirement date will have different ages and life expectancies at the time of retirement. Additionally, in terms of withdrawal preferences, one investor may choose to withdraw a large portion of funds just past the target date (e.g., to purchase a vacation home), while another investor may seek to conserve as much principal as possible (e.g., to meet bequest goals). TDF investment allocations are not customized for such idiosyncratic issues associated with an individual's decumulation phase.[11]

III. MANAGING "TO TARGET DATE" VS. "THROUGH TARGET DATE"

Some TDFs only adjust fund asset class allocations up "to the target date," while others adjust allocations "through the target date." In the latter class, targeted fund allocations continue to change past the target date, typically becoming more conservative. Historically, one rationale for managing only "to the target date" was that it would not be possible for a manager to align one fund with the varied investor choices associated with the decumulation phase (as discussed above). However, most TDFs offered by large providers are currently managed "through the target date."[12] In order to take a quantitative approach to managing "through the target date," general assumptions about investor life expectancy must be made.

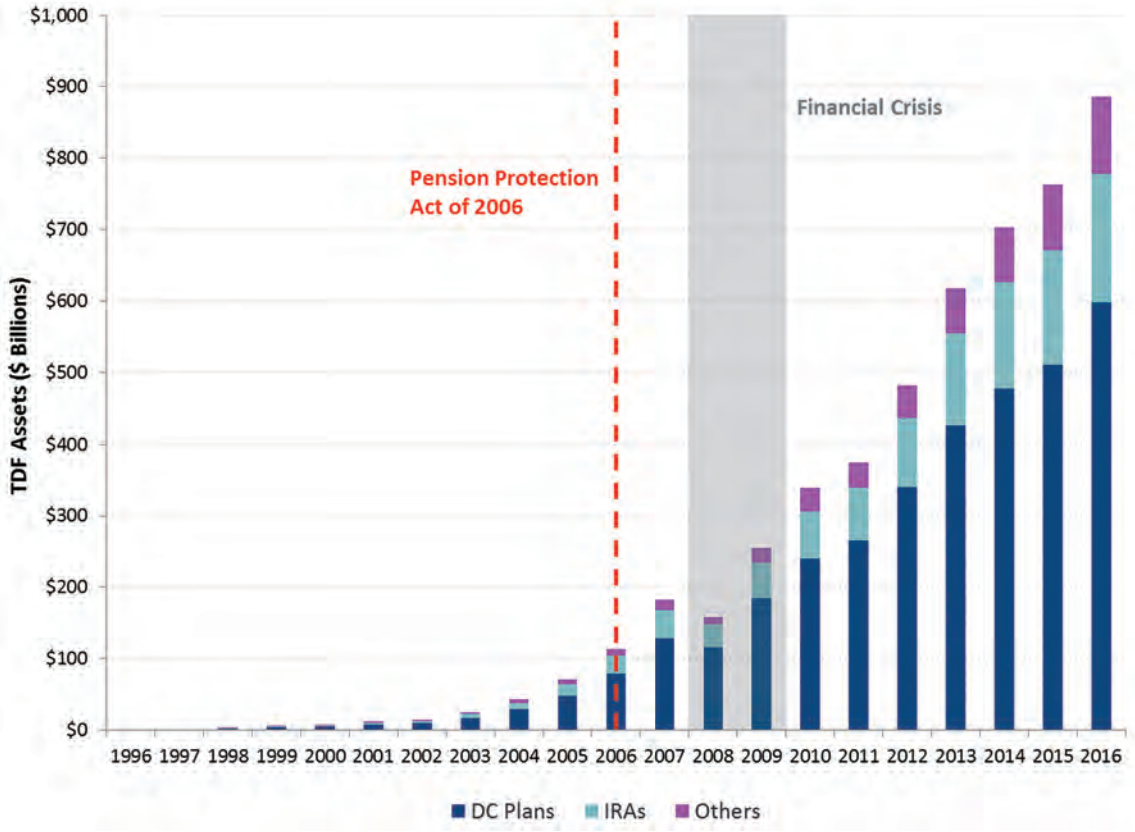
Some TDFs state directly that an asset allocation policy extending up to 30-years into retirement is assumed, while other TDFs disclose no explicit assumption.[13] For example, TIAA materials indicate that it designs its Lifecycle (TDF) portfolios considering a 30-year retirement period,[14] while Vanguard TDF prospectuses refer to the retirement period as "many years."[15]

IV. TDF GROWTH TRENDS

> Though TDFs were first introduced in the early 1990s,[16] TDF assets have seen extraordinary growth over the past decade and currently exceed $1 trillion.[17]

Morningstar reports that TDF assets it tracked reached an all-time high of $880 billion in 2016.[18] Similarly, the Investment Company Institute reported that as of December 2016, there were $887 billion in TDF mutual fund assets (see Figure 2) and estimated that TDF assets held solely within reported DC plans (that include 401(k)s) and IRAs totaled approximately $778 billion, approximately 12-times the level reported at year-end 2005.[19]

FIGURE 2 Target Date Mutual Fund Assets ($ Billions)



Source: "Report: The U.S. Retirement Market, Fourth Quarter 2016," Investment Company Institute, March 2017, Table 21, "Target Date Mutual Fund Assets," accessed June 15, 2017, at www.ici.org/info/ret_16_q4_data.xls.

Beyond TDF nominal growth, data shows that TDFs have become widely used by investors saving for retirement.[20] Vanguard, the funds company with the largest amount of TDF assets under management, reports that 70% of Vanguard DC plan participants that were offered TDFs were invested in a TDF(s) at the end of 2015.[21] This is up more than 200% from the 2006 level of 22%.[22]

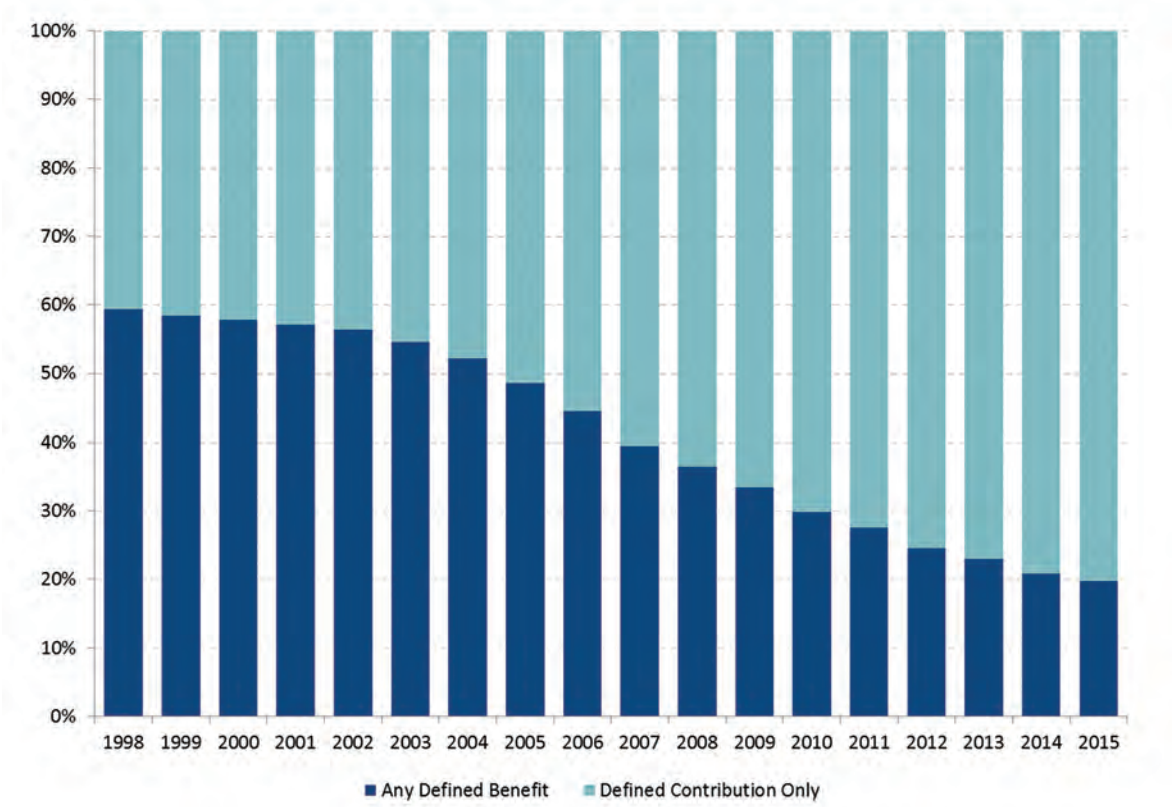
The proportion of aggregate retirement savings invested in TDFs has also consistently increased over time. A Plan Sponsor Council of America (PSCA) survey reported that TDF assets comprised approximately 19.8% of 401(k) participant assets in 2015,[23] ranking second amongst all fund types. This is up from the 12.4% reported by the PSCA survey for 2011.[24] Similarly, in terms of TDF growth as a portion of retirement investments, Vanguard reported that at year-end 2015, 26% of its administered DC plan assets were invested in TDFs. This level is up from 14% in 2011, 9% in 2009, and 5% in 2007.[25]

TDF's share of the retirement investment pie is expected to continue to increase. Consistent with this view, Vanguard reports that 46% of all 2015 contributions made to its DC plans were directed to TDFs.[26] Further, one research firm has predicted that 88% of all new 401(k) contributions will be directed into TDFs by the end of 2019.[27]

V. TDF GROWTH DRIVERS

A few key drivers have spurred the growth in TDFs assets. The first is the well-known shift by both private and public employers away from offering defined benefit (DB) (e.g., pension plans), to offering DC plans. The chart below illustrates the magnitude of this shift based on data from Willis Towers Watson. By 2005, DB plans were being offered by less than half of Fortune 500 companies, and by 2015, that percentage had fallen to 20%. Assets for DC plans have consequently grown.

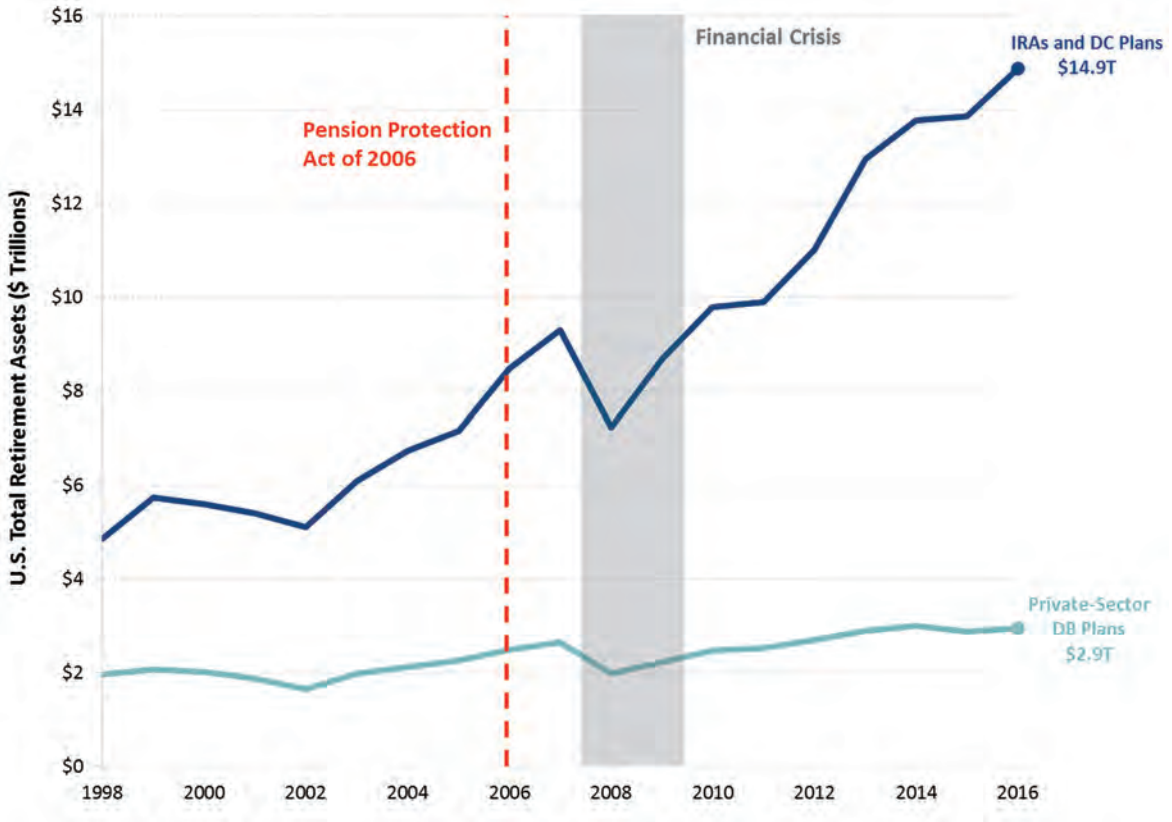
FIGURE 3 Retirement Plans Offered to New Hires by Fortune 500 Companies



Source: Brendan McFarland, "A Continuing Shift in Retirement Offerings in the Fortune 500," Willis Towers Watson Insider 26(2) (February 2016), Figure 1, p. 2, accessed January 25, 2017, www.towerswatson.com/en-US/Insights/Newsletters/Americas/insider/2016/02/a-continuing-shift-in-retirement-offerings-in-the-fortune-500.

As a greater percentage of employees have, by necessity or choice, become DC plan investors, it is not surprising that the nominal amount of DC assets, including TDF assets, have increased substantially as shown in Figure 4. As of the fourth quarter of 2016, Americans reportedly held $7.0 trillion in employer-based DC retirement plans, of which $4.8 trillion were 401(k) plans.[28] Outside of employer sponsored retirement plans, IRA assets totaled an even larger $7.9 trillion.[29]

FIGURE 4 U.S. Total Retirement Assets ($ Trillions)



Source: "Report: The US Retirement Market, Fourth Quarter 2016," Investment Company Institute, March 22, 2017, Table 1, "US Total Retirement Assets," accessed June 15, 2017, www.ici.org/info/ret_16_q4_data.xls.

Even beyond general growth in non-DB retirement assets, TDF assets have grown significantly relative to other investment options. The Pension Protection Act of 2006 (PPA 2006) served as the most significant catalyst for this growth. Specifically, under the federal regulations implementing the Qualified Default Investment Alternative (QDIA)[30] provisions of the PPA 2006, TDFs were explicitly identified as a default alternative or "safe harbor" investment class where un-allocated employee DC contributions could be directed.[31] The identification of TDFs as a default alternative allowed employer fund administrators, who are fiduciaries under the Employee Retirement Income Security Act (ERISA),[32] to limit potential fiduciary liability associated with choosing investments for employees.[33] As a result of the safe harbor status, many fund administrators began directing significant amounts of unallocated employee contributions into the TDF investment class. Prior to the QDIA delineation of "safe harbor" investments, fund administrators had typically directed unallocated employee investments into money-market mutual funds or other ultra-safe funds in order to avoid potential fiduciary liability for potential investment losses.

According to Vanguard, a significant portion of DC contributions continue to be automatically directed into TDF funds by fund administrators.[34] Among plans that designated a QDIA, 95% designated a TDF as the default alternative in 2015,[35] up from 80% in 2009.[36] Though the QDIA clearly jump-started TDF growth around 2006 and continues to help bolster TDF asset totals, recent surveys indicate that the majority of retirement investors who are now knowledgeable about TDFs appear to understand the fundamental TDF objectives and design features and many purposefully choose to invest in TDFs.[37]

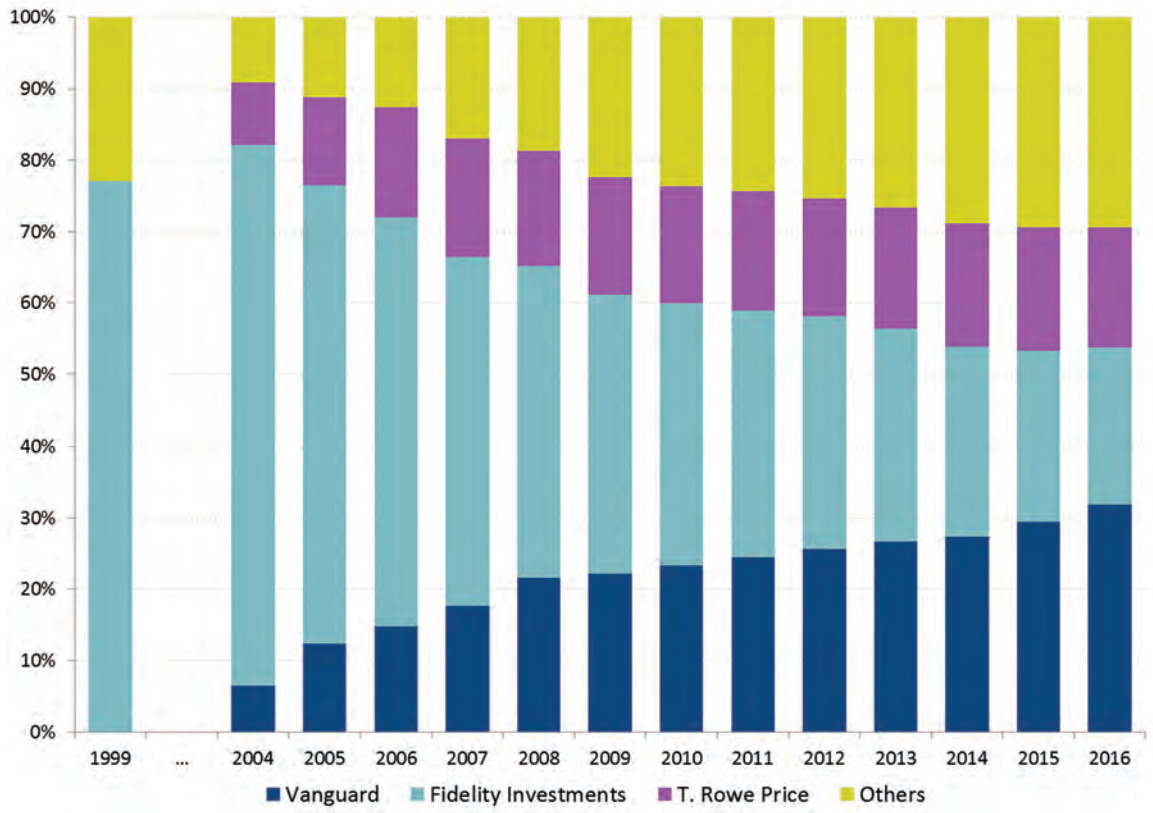
VI. TDF MANAGEMENT COMPANY TRENDS

Given the massive growth in TDFs, it is not surprising that numerous fund management companies have entered the TDF space. As of 2016, at least 22 fund companies managed TDF assets exceeding $1 billion.[38]

In recent years, some fund companies have gained market share, however three companies continue to dominate the sector: Vanguard, Fidelity Investments, and T. Rowe Price. These three fund companies were early TDF market entrants and offer relatively low-fee TDFs. Though their aggregate market share has declined from around 90% prior to the PPA 2006, they continue to maintain over 70% of the TDF mutual fund market, as shown in Figure 5.[39]

When considering both mutual fund and CIT TDFs, Vanguard reportedly has the highest market share of any company. According to Sway Research from year-end 2015, "Vanguard, which boasts low cost passively managed Target-Date portfolios, is the most dominant Target-Date player, managing nearly a third of the $1.1 trillion of Target-Date mutual fund and CIT assets within its proprietary offerings."[40]

FIGURE 5 Firm Market Share of Target Date Mutual Funds



Notes and Sources: Data between 2000 and 2003 are not available. "Target-Date Fund Landscape," Morningstar Annual Reports, 2009-2017.

VII. CLOSED ARCHITECTURE VS. OPEN ARCHITECTURE TDFS

Rather than creating new pools of investments from scratch, most TDF management companies simply make investment allocations among existing funds in proportions that they believe create an appropriate risk/return portfolio for a given target date. This is consistent with TDFs typically existing as a fund of funds product. Some TDF managers only purchase underlying funds managed by their own fund management company (e.g., a Vanguard TDF might invest only in existing Vanguard equity and bond funds). Such TDFs are known as having a "closed architecture." Alternatively, a TDF manager may employ an "open architecture" approach, where at least some investment allocations are made to underlying funds offered by third-party fund management companies. An open architecture structure is common and often necessary for smaller fund management companies that do not offer every type of sub-fund desired by the TDF fund manager (e.g., a commodity fund).

VIII. TDF ASSET ALLOCATION: "GLIDE PATHS"

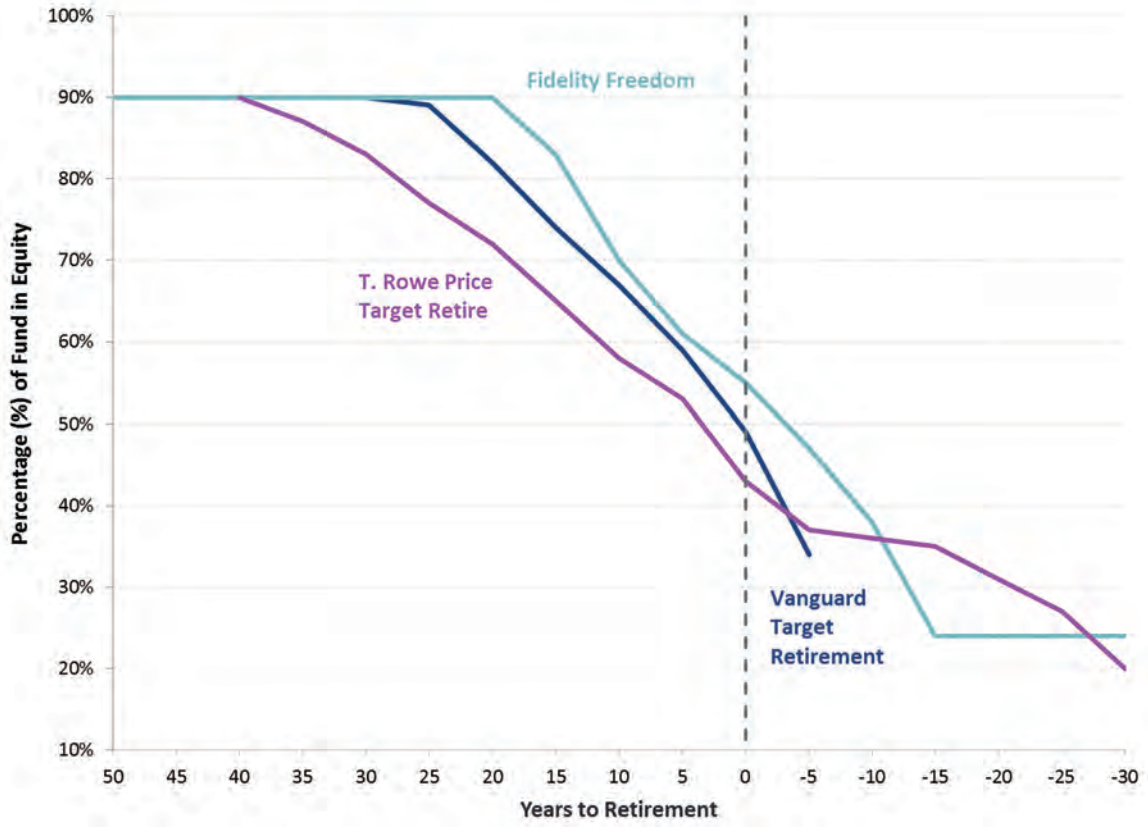
Though there are many investment categories and approaches utilized by current TDF managers, a general axiom within the TDF universe is that the portion of a portfolio invested in equity (e.g., common stock) is reduced as the target date approaches. This declining exposure to equity over time is known as the equity glide path. Each family of target date funds chooses an equity glide path for each target date fund.

As stated in the Vanguard Target Retirement Funds Prospectus:

> The Fund's asset allocation will become more conservative over time, meaning the percentage of assets allocated to stocks will decrease while the percentage of assets allocated to bonds and other fixed income investments will increase.[41]

As indicated in the Vanguard disclosure, TDFs generally attempt to take on a more conservative risk posture as the target date is approached or passed. This is because investors who are nearing or are already in retirement are generally viewed as being less willing to bear significant downside risk. The targeted equity glide paths of the largest three TDF management companies are shown below. Though the paths are similar, there are meaningful differences in targeted equity exposure over time, which can create significant performance differences.

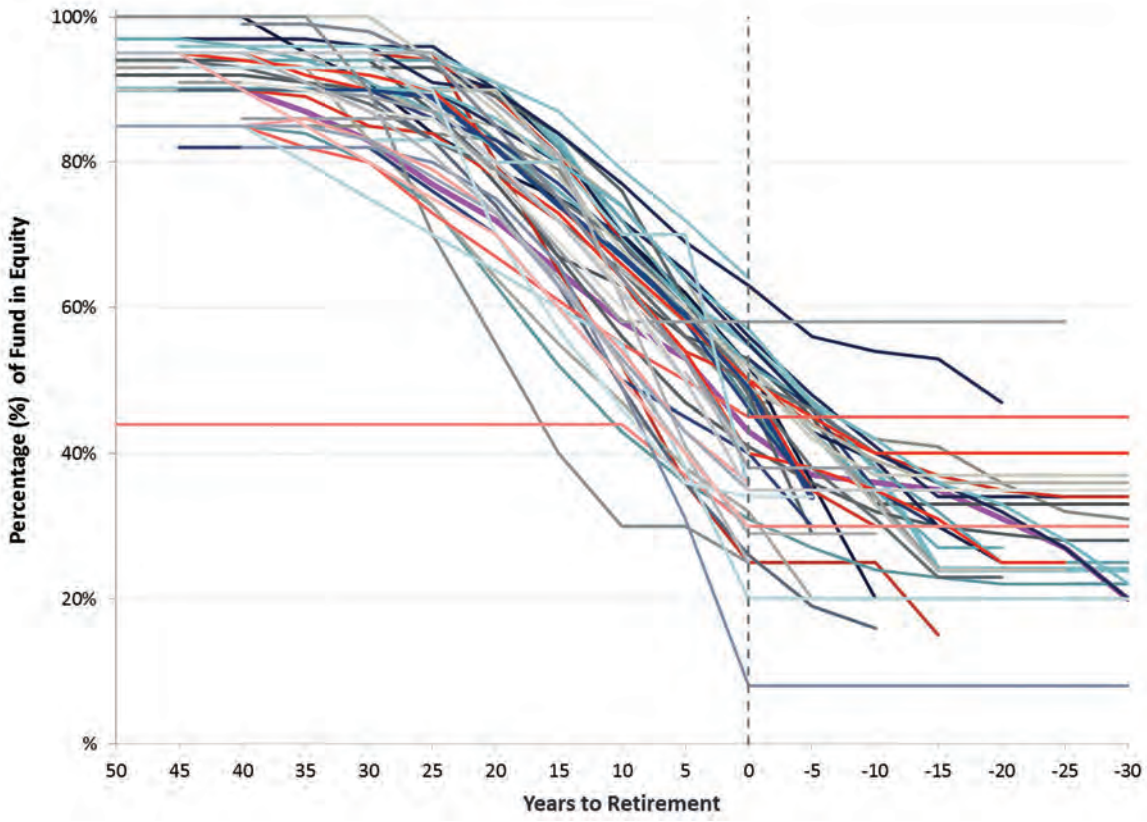
FIGURE 6 Glide Paths of Top Three TDF Providers



Source: Jeff Holt et al., "2016 Target-Date Fund Landscape," Morningstar, April 12, 2016, Appendix 2, "Complete Glide-Path Equity Allocations by Target-Date Series %," pp. 83-84.

The next chart depicts the glide paths of a wider range of TDF offerings, illustrating much greater variations in the target equity percentage. Clearly different views are espoused by fund management companies as to the appropriate portion of equity relative to a given target date. The variation in target equity percentage coupled with differences in the level of fees charged to investors can lead to meaningful differences in performance across TDFs. The impact of fees on the performance of TDFs will be a topic of a future whitepaper in this series.

FIGURE 7 Glide Paths of Various Funds



Source: Jeff Holt et al., "2016 Target-Date Fund Landscape," Morningstar, April 12, 2016, Appendix 2, "Complete Glide-Path Equity Allocations by Target-Date Series %," pp. 83-84.

A standard equity investment is typically an ownership interest in a company (e.g., common stock) that does not contractually require payments (e.g., dividends, return of investment). As such, equity is generally viewed as having higher financial risk than, for example, a high quality debt security, which contractually requires defined payments and is higher in a company's capital structure than equity.[42]

The reduction in equity exposure over time by most TDFs as a risk-reducing mechanism is generally supported by historical performance statistics of asset classes.[43] Over long historical periods, the volatility or risk of U.S. stock returns as expressed by the standard deviation of returns tends to be higher than that of bond returns.

Of course, the average (mean) return of stocks is also higher than bonds, reflecting the typical trade-off between risk and return. Table 1 below shows the average monthly returns and standard deviations of U.S. large capitalization stocks and intermediate-term government bonds in the post-World War II era, based on data from Ibbotson.

TABLE 1 Average Monthly Investment Returns and Standard Deviation, 1945-2015

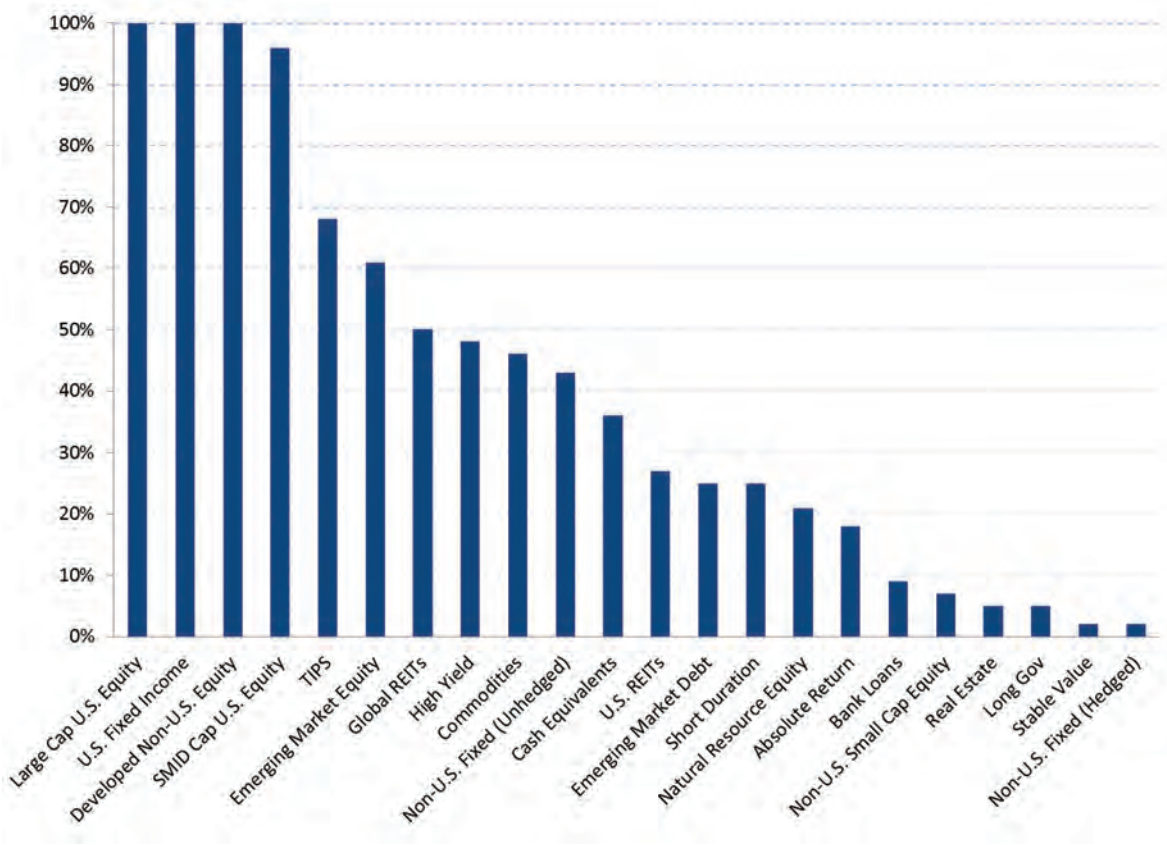
	Mean Total Return	Standard Deviation of Returns
Large Capitalization Stocks	0.97%	4.17%
Intermediate-Term Government Bonds	0.45%	1.36%

Notes and Sources: Roger G. Ibbotson, 2016 SBBI Yearbook: Stocks, Bonds, Bills, and Inflation: U.S. Capital Market Performance by Asset Class 1926–2015, (Hoboken, New Jersey: John Wiley & Sons, Inc., 2016), Appendices A-1 and A-10. Calculations are done by Brattle.

Despite TDF managers' common practice of reducing equity exposure to a relatively low level as the target date is approached or passed, this is not optimal for every individual. Academic papers and our own research indicate that if the amount of periodic income required by a retiree is relatively large in relation to the total value of invested retirement assets, there is often a higher probability of successfully meeting such income requirements by maintaining larger equity allocations well into retirement.[44] This research implicitly and quantitatively highlights the issue raised earlier: due to idiosyncratic differences among individuals, particularly differences in attributes and preferences during the decumulation phase, a standard TDF asset allocation may not be in the best interest of an individual.

Beyond simple equity glide paths, in recent years, more granular asset class target allocations have been reported by many TDFs.[45] Broadly, the number of investment classes utilized by TDFs has grown, consistent with a general increase in the availability/liquidity of non-traditional asset classes and strategies. The asset classes employed go well beyond traditional long debt and equity investments. For example, commodities, which are often viewed as a diversifying asset class (from equity and debt) and also an inflation hedge, have become more prevalent within some TDFs in recent years.[46] Further, some fund management companies, including TIAA, also make allocations to direct holdings of real estate.[47] Figure 8 highlights that traditional long debt and equity investments are ubiquitous in TDFs and are supplemented by additional assets with varying degrees of prevalence.

FIGURE 8 Prevalence of Various Asset Classes across Glide Paths



Source: James Veneruso, "Target Date Funds: Finding the Right Vehicle for the Road to Retirement," Callan Investments Institute, September 2015, Exhibit 7, "Prevalence of Various Asset Classes Across Glide Paths," p. 6, accessed June 20, 2017, www.callan.com/wp-content/uploads/2017/02/Callan-TDF.pdf.

As recently noted by the authors of an article appearing in The Center for Retirement Research at Boston College:

> The typical TDF invests in 17 funds on average. These holdings include emerging markets, real estate, and commodities… And the prevalence of these specialized assets has increased over time.[48]

The article further notes:

> Analysts have suggested three possible reasons for the growing popularity of specialized asset classes. First, some TDFs may be trying to stand out from their competitors. Second, these asset classes were identified as hot areas by the financial community in general. Third, fund managers may believe that adding such investments will lower risk through diversification.[49]

Consistent with the third point above, a custom TDF marketing brochure from J.P. Morgan's asset management area notes:

> Efficient diversification can increase expected return, while actually lowering risk. This level of diversification generally requires a much broader range of asset classes than what is typically found in many TDF strategies, with traditional stocks and bonds serving as a portfolio core and extended and alternative asset classes used to enhance return and reduce overall risk.[50]

Despite the growth in the number of investment classes used by many TDFs in recent years, adding too many classes can reduce net returns. Research indicates that so-called "over-diversification" may have a negative impact on fund of fund returns.[51]

Though any given TDF is meant to be appropriate for many individuals with similar target dates, the types and number of asset classes employed by TDF managers can vary significantly, as illustrated in Figure 7. This is another feature highlighting TDF heterogeneity.

In this regard, Morningstar states:

> Target-date funds are by no means a uniform investment type. Depending on the glide-path philosophy, the subasset classes used, the nature and quality of the underlying investments, and a host of other factors, target-date funds can display markedly different risk and return characteristics.[52]

During the financial crisis that began in 2007, TDFs with the same common target date exhibited striking differences in annual returns.

In Table 2, we document the dispersion in TDF returns for a subset of funds with target dates within 15 years of the financial crisis. It is notable that each of the funds' large declines in value exhibited in 2008 was followed by large percentage gains in 2009. This is at least partly due to successful Federal Reserve and government intervention and reflation efforts. However, it is important to remember that the order of returns matters, and that a percentage decline in a fund followed by an even larger percentage gain may not result in the full recovery of the dollar amount of value lost. For example, a $100 investment in T. Rowe Price's 2020 Fund at the start of 2008 would have dropped to $66.5 by year-end, a 33.5% decline. Though the fund gained an even larger 34.2% during 2009, that gain on the $66.5 base would only result in a 2009 year-end balance of $89.24.

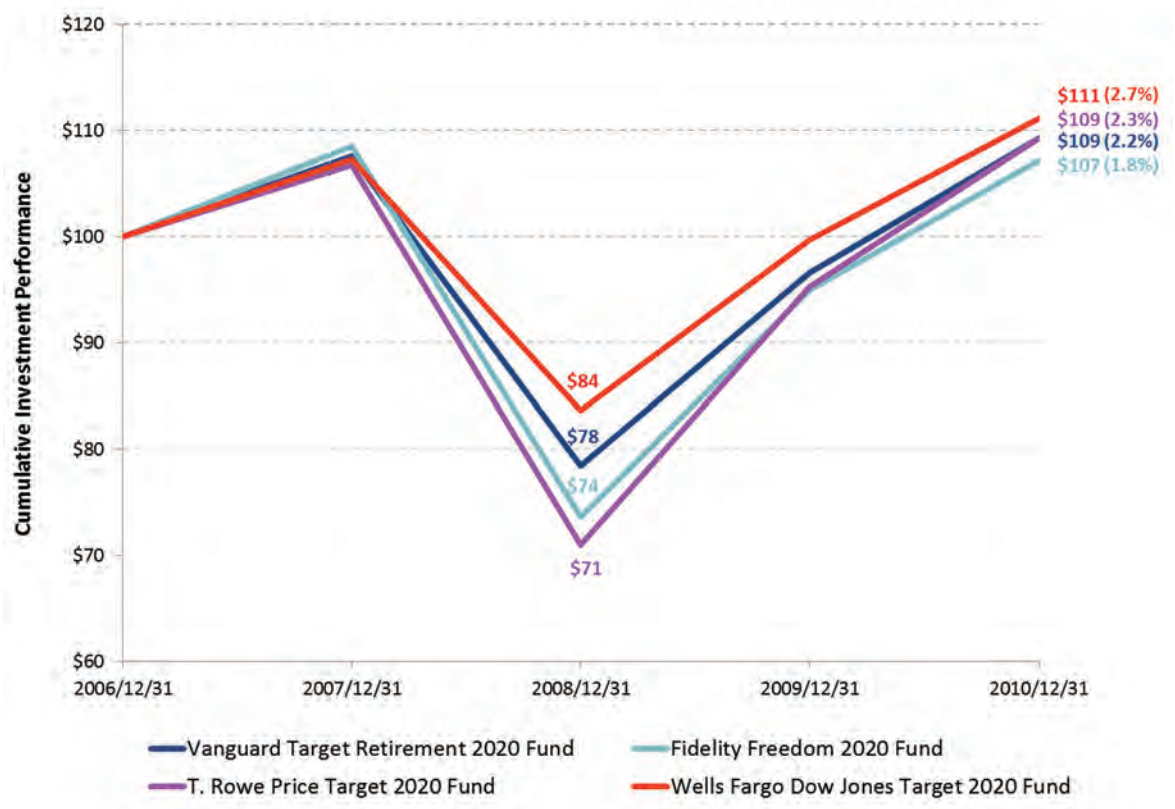
TABLE 2 Returns of Selected TDFs, 2007 – 2010

	2007	2008	2009	2010
2010 Funds				
Fidelity Freedom 2010 Fund	7.4%	-25.3%	24.8%	11.7%
Vanguard Target Retirement 2010 Fund	7.7%	-20.7%	19.3%	11.4%
T. Rowe Price Target 2010 Fund	6.7%	-26.7%	28.0%	12.7%
Wells Fargo Dow Jones Target 2010 Fund	6.9%	-11.0%	12.6%	8.8%
2015 Funds				
Fidelity Freedom 2015 Fund	7.8%	-27.2%	25.6%	11.8%
Vanguard Target Retirement 2015 Fund	7.6%	-24.1%	21.3%	12.5%
T. Rowe Price Target 2015 Fund	6.8%	-30.2%	31.4%	13.8%
Wells Fargo Dow Jones Target 2015 Fund		-16.5%	15.8%	10.0%
2020 Funds				
Fidelity Freedom 2020 Fund	8.5%	-32.1%	28.9%	12.9%
Vanguard Target Retirement 2020 Fund	7.6%	-27.0%	23.1%	13.1%
T. Rowe Price Target 2020 Fund	6.7%	-33.5%	34.2%	14.7%
Wells Fargo Dow Jones Target 2020 Fund	7.3%	-22.1%	19.2%	11.5%

Notes and Sources: Bloomberg and Morningstar. Returns shown are historical total returns based on the net asset value (NAV) of each fund.

Figure 9 illustrates as an example the change in value of 100 dollars invested in the 2020 subject funds at the start of 2007 through the end of 2010 (similar but less volatile patterns appear in the 2010 and 2015 subject funds). Primarily as a result of the financial crisis, the funds dropped sharply during 2008 and did not recover to and exceed their 2007 initial values until sometime in 2010. The 4-year annualized returns for each of the funds during this period was less than 3%.

FIGURE 9 Select 2020 TDF Cumulative Investment Values and Annualized Returns, 2007 – 2010



Notes and Sources: Bloomberg and Morningstar. This chart shows the 4-year cumulative investment performance of selected 2020 TDFs assuming a $100 investment in each fund at the beginning of 2007. Annualized returns for the period, shown in parentheses, are calculated based on the net asset value (NAV) of each fund.

IX. TARGET ALLOCATIONS VS. ACTUAL INVESTMENT ALLOCATION

Individual TDFs generally detail their investment class targeted allocations (by percentage of total) in prospectuses. The granularity of the class targets may vary, but many funds use quantitative approaches to arrive at very specific targeted percentages which may be reported at the 1/10th of one percent level (0.1%). Despite

this and the fact that TDFs rebalance portfolios on an ongoing basis, many TDFs have leeway to migrate away from their listed target allocations. The amount of these so-called "tactical allocations" can vary by fund and may be at the discretion of the portfolio manager.[53]

For example, TIAA-CREF Lifecycle Funds literature states:

> At most, we anticipate tactical asset allocation to account for about 10% to 20% of the relative performance of the Lifecycle Funds versus their composite benchmark in any given year. The remaining 80% to 90% of relative performance of the Lifecycle Funds remains a function of the performance of the portfolio managers of the underlying funds relative to their respective sub-asset categories, as well as the strategic glidepath decision.[54]

Some level of natural variation from investment class targets may occur in an effort to reduce costs and turnover associated with perfect rebalancing to targets. However, many TDFs report using tactical allocations to opportunistically deviate from specified targets. For example, in a rapidly rising equity market, a TDF with a 90% equity target and sufficient tactical leeway could move to 100% equity. Some view the tactical allocations as a positive, in that they can allow managers to take advantage of unusually high returns or avoid perceived losses. A number of studies show that broad asset allocation decisions determine a large portion of fund return differences.[55] However, given competitive pressures among TDFs and required disclosures that are focused on short-term performance, the ability to tactically allocate away from targets may lead some TDF managers to chase returns in hot markets or "market-time."

X. EMERGING TDF FIDUCIARY ISSUES

ERISA sets out various standards required of DC plan fiduciaries. The Act defines "fiduciary" not in terms of formal title but rather in functional terms of control and authority over the plan. DC plan fiduciaries normally include plan trustees, plan administrators, members of a plan's investment committee, or anyone who provides investment advice to a plan for compensation.[56]

A fundamental fiduciary duty under ERISA is the duty of care or prudence, sometimes known as the prudent man rule.

This duty, from ERISA's section on "Fiduciary Duties," states:

> …a fiduciary shall discharge his duties with respect to a plan… with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.[57]

Though TDFs are designated as a "safe-harbor" investment-type under the PPA 2006, plan administrators continue to have fiduciary responsibilities, and as such, cannot blindly include particular TDFs within DC plan offerings. Under ERISA, the investment manager of an externally sourced TDF (e.g., a 2035 TDF offered by Vanguard), who is effectively an outsourced service provider, is generally not a plan fiduciary.[58] As such, DC plan sponsors retain the responsibility to evaluate relevant aspects of TDFs, such as underlying investments and

future targeted allocations. Consistent with this point, in 2013 the DOL issued guidance to assist plan fiduciaries in their selection and monitoring of plan TDFs.[59] One key point within the guidance is that plan fiduciaries should establish a process for the comparison and selection of TDFs in relation to the plan's goals, considering TDF performance, fees, and expenses.[60]

> Within ERISA there is a potential tension between the "prudence" duties on the one hand and diversification and reasonable expense expectations on the other.

If the majority of fiduciaries offering TDFs to their employees offer TDFs that primarily invest in long holdings of traditional equity and debt securities whose transaction costs are relatively small, then another fiduciary offering non-standard TDFs (that is, TDFs that do not primarily invest in long holdings of traditional equity and debt securities) could be viewed as failing ERISA's prudence standard. In fact, the prudence standard, if interpreted as requiring plan fiduciaries to select TDFs similar to those selected by most other seemingly prudent plan fiduciaries, could hinder the use of potentially superior TDF strategies for concern of being viewed as "outliers," increasing legal and compliance risks.

For example, offering employees a TDF designed to avoid potentially significant downside risk by sacrificing some upside (e.g., purchasing options) or by diversifying beyond the most common and liquid long asset classes/strategies may provide superior "through-the-cycle" performance. Yet such a TDF could be subject to criticism as a high-cost imprudent outlier.

XI. DOL'S FIDUCIARY RULE AND IMPACT ON TDFS

While there is still some uncertainty with respect to the ultimate fate of the DOL's Fiduciary Rule, on May 22, 2017 the DOL, after a 60-day delay and review, reported that implementation would begin on June 9, 2017. Even prior to the final rule's approval and implementation date, some major financial firms had begun to alter their processes and fee structures related to retirement investment products and advice.

Broadly, the Fiduciary Rule moves broker-dealers and affiliated registered representatives or RRs to a fiduciary "best interest" standard from the less strict suitability standard, with respect to their investment recommendations on non-ERISA retirement accounts, such as IRAs.

As stated in *Law360*:

> The fiduciary rule, promulgated under the Obama administration in April 2016, requires financial professionals who advise retirement account holders to act in the best interests of their clients when recommending investment products, a higher standard than the current approach of promoting products that are merely suitable to an investor.
>
> Advisers and broker-dealers that fall under the expanded definition of a fiduciary will largely be prohibited from collecting commissions unless they take advantage of the so-called best interest contract, or BIC, exemption by entering into a contract with clients affirming they will uphold the clients' best interests.[61]

ERISA has long required fiduciary standards with respect to any party with control or authority over an employer-sponsored retirement plan, such as a 401(k). Furthermore RIAs have long been held to a fiduciary standard, promulgated under the Investment Advisers Act of 1940,[62] with respect to any investment advice. However, the DOL's Fiduciary Rule effectively holds RRs who provide recommendations on non-ERISA retirement investment accounts, such as IRAs, to a fiduciary standard. As detailed above, IRAs represent a multi-trillion dollar market with hundreds of billions invested in TDFs.[63]

> Initial reports indicate that the new Fiduciary Rule has led to reductions in brokerage account types where customers are charged on transactions. Such accounts, where brokers are typically compensated through sales commissions, are viewed as more subject to conflicts of interest, as there may be broker incentives to recommend frequent trading or to recommend relatively high fee products, both of which may be viewed as inconsistent with the client's best interest.

Conversely, non-commission accounts such as fee-based accounts and self-directed brokerage accounts have increased.

The *Wall Street Journal* reported:

> Fee-based accounts are favored under the fiduciary rule because they don't give a broker incentive to push one product over another for a commission. Self-directed brokerage accounts also have benefited from the rule because they allow investors who trade infrequently to minimize costs.[64]

In terms of TDF recommendations by brokers handling retirement accounts, a broker would have no direct commission-based incentive in a fee-based account to recommend a particular TDF; however, even fee-based accounts may entail certain indirect or firm-level incentives that influence broker behavior.

A simple example involving a TDF recommendation potentially meeting the RRs suitability standard but failing the new best interest standard would be one recommending the purchase of a TDF that is generally suitable for an investor, but whose cost is higher than another virtually identical TDF. Proponents of the DOL rule argue that it protects investors from RRs who may have an incentive to recommend higher-cost products that pay RRs higher commissions, but provide no offsetting advantages to the investor.

One major argument against the DOL's Fiduciary Rule is that it could result in a large increase in the number of lawsuits, as it creates a new private right of action for investors. Specifically, plaintiffs who realize sub-optimal investment results after some subjective period could, with the benefit of hindsight, file lawsuits complaining that investment recommendations were not in their best interest at the time, even if these recommendations were reasonable.

> Given the wide dispersion of TDF glide paths, investment strategies, and expense ratios detailed in this paper, significant performance differences have and will continue to exist across TDFs, particularly through market cycles.

It is not difficult to imagine IRA account holders', who receive a purchase recommendation via a brokerage firm for a specific TDF investment, filing lawsuits a few years later if the subject TDF realized lower returns than other available TDFs. In such cases, maintaining documentation as to why the particular TDF was viewed at the time to be in the best interest of the client will be important for brokerage firms seeking to mitigate legal risk.

Beyond the obvious issues in the example of identical TDFs that involve different investor fees, the analysis of the value provided from a TDF versus its costs can be complex and multi-faceted. Though one may easily show, with the benefit of hindsight, that a more expensive investment option provided relatively poor performance, this does not mean that the more expensive product was a sub-optimal choice.

The value of important features including investment manager experience, risk management systems, and the implementation of hedging strategies may not show benefits in terms of relatively higher investment returns in certain time periods. However, such features, which can serve as insurance, may be prudent and valuable, particularly in turbulent markets. Just because a car owner pays for car insurance for five years and never has an accident or claim does not mean the insurance had no value; it may be that the insurance more than pays for its cost given a major crash in year six. Given the long-term nature of TDFs and potential litigation that may be sparked by the Fiduciary Rule, the quantification and valuation of proper risk management, experience, and other less tangible factors is likely to become an increasingly important area of expertise for fiduciaries and experts.

XII. SELECTED RECENT LITIGATION INVOLVING TDFS

A. JACOBS V. VERIZON COMMUNICATIONS, INC.

TDFs have been the subject of recent lawsuits alleging breaches of fiduciary duties under ERISA. For example, in *Jacobs v. Verizon Communications, Inc.*, plaintiff alleges that the "Verizon Defendants designed an investment structure for the Verizon Plans that was overly complex, overly risky, and inappropriate for the average Verizon employee."[65] According to the Complaint, defendants violated their fiduciary duties to plan participants under ERISA given the inappropriate nature of the investment options, which involved excessive risks as well as excessive fees.[66] The Complaint further alleged that the defendant's provision of Verizon TDFs "added a second layer of investment management fees"[67] and that the addition of certain "specialty" asset classes, including a global high yield bond fund, to the asset allocation of the Verizon TDFs "added significant levels of risk and complexity to the Verizon TDF series."[68] The plan fiduciaries allegedly violated their fiduciary duties of disclosure under ERISA by failing to provide plan participants with "the opportunity to obtain sufficient information to make informed decisions" regarding their investment alternatives under the plan.[69] The Complaint also alleged that the plan fiduciaries breached their duty of prudence in the design and management of the Verizon TDFs, and by failing to adequately monitor the performance of certain funds included in the Verizon TDFs.[70]

B. MEINERS V. WELLS FARGO & COMPANY

In another matter, *Meiners v. Wells Fargo & Company,* the plaintiff filed suit alleging that defendants violated their fiduciary duties of loyalty and prudence under ERISA by engaging in "a practice of self-dealing and imprudent investing of Plan assets by funneling billions of dollars of those assets into Wells Fargo's own proprietary funds."[71] The Complaint specifically alleged that the defendants "designed and maintained a system to maximize the amount of plan assets invested into" TDF mutual funds.[72] The Complaint further alleged that the Wells Fargo TDFs "cost on average over 2.5 times more than comparable target date funds while… substantially and consistently underperforming those comparable funds."[73] On May 25, 2017, district court Judge David S. Doty granted defendants' motion to dismiss, with prejudice, thereby barring plaintiff from re-filing any amended complaint in the case.[74] Plaintiff has filed an appeal, which is currently pending with the Eighth Circuit Court of Appeals.[75]

C. SULYMA V. INTEL CORPORATION INVESTMENT POLICY COMMITTEE

The tension between the "prudence" and "reasonable expense" responsibilities on the one hand and the "diversification" responsibility of a plan fiduciary was the focus in a recent ERISA case in the Northern District of California.

In *Sulyma v. Intel Corporation Investment Policy Committee*, plaintiff claimed:

> Defendants breached their fiduciary duties by (a) investing a significant portion of the [Intel 401(k) Savings Plan's and the Intel Retirement Contribution Plan's] assets in hedge fund and private equity investments which presented unconventional, significant and undue risks and unduly high fees and costs, and (b) adopting asset allocation models and asset allocations for participant accounts that departed dramatically from prevailing standards employed by professional investment managers and plan fiduciaries.[76]

The Intel Retirement Plans Investment Policy Committee, the fiduciary for both plans at issue, tailored a suite of target date portfolios consisting of allocations in nine underlying funds. Among these nine funds were various funds consisting of "alternative investments," including the Alternative Investment Fund, which invested heavily in private equity partnerships, and a hedge fund.[77] Plaintiff alleged that the Investment Committee "dramatically altered the asset allocation model" and significantly increased the at-issue funds' exposure to hedge fund and private equity investments, from 2009 through 2014, consequently resulting in high fees and performance inferior to that of "peer TDFs."[78]

In the Motion to Dismiss, defendants outlined several defenses, including contending that "[Plaintiff's] claims fail because they rely on generalized allegations unconnected to the Plans' actual investments and on hindsight comparisons to mutual funds that are not comparable."[79] They explained that, in response to the 2008 financial crisis, the fiduciaries "diversified Intel's retirement portfolios by increasing the asset allocation to alternative investments such as selected hedge funds and private equity partnerships" in order to "generate optimal long-term, risk-adjusted returns and steadier performance while protecting the Plans' participants against excessive equity market volatility and sharp fluctuations in the value of retirement assets."[80]

> The defendants argued that this downside protection comes at the price: "such diversification could cause portfolios to lag behind equities during a sustained market run-up" and "would entail higher costs because the alternative investments are actively managed strategies."[81]

On March 31, 2017, the Court issued an Order granting summary judgment in favor of Defendants.[82] All claims were dismissed based on the statute of limitations, as the court found the plaintiff had "actual knowledge" of the underlying facts (due to financial disclosure documents) more than three years prior to their filing of the lawsuit. Plaintiff has filed an Appeal, which is currently pending with the Ninth Circuit Court of Appeals.[83]

D. TUSSEY V. ABB, INC.

Another recent matter has focused on the responsibilities of plan fiduciaries to monitor plan investments which included TDFs and assess and re-assess the reasonableness of fees. In *Tussey v. ABB, Inc.*,[84] the Eighth Circuit initially affirmed a determination that ABB violated ERISA by failing to consider the reasonableness of fees charged by its fund record-keeper.[85] The district court judge had originally ruled in favor of plaintiff, finding in part that "ABB never calculated the dollar amount of the recordkeeping fees the Plan paid… via revenue sharing arrangements,"[86] even after an outside consulting firm told ABB that it was overpaying for recordkeeping fees.[87] In determining the $13.4 million that the plan overpaid for recordkeeping costs, the district court credited plaintiffs' expert witness, who used fees paid by a similarly sized retirement plan for Texas employees as the comparator, and that this was in line with trends as to what were reasonable revenue-sharing earnings for other plans.[88] Subsequent case proceedings have focused on the issue of whether Plaintiffs were capable of proving damages against the defendant plan fiduciaries. While the district court originally found that Plaintiffs had failed to satisfy their burden of proof as to the issue of damages,[89] the Eighth Circuit found that the district court incorrectly limited itself in assessing the damages question, and therefore has vacated and remanded the case back to the district court to re-assess Plaintiff's damages.[90]

XIII. CONCLUSION

The size, heterogeneity, and complexity of the TDF market have clearly increased over recent years. This backdrop along with the evolving regulatory frameworks and legal decisions make TDFs an important area to monitor going forward.

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ENDNOTES

1. Some target date funds are designed to be used for 529 Plan education savings programs, and thus their target dates aren't retirement-based.
2. As an example, in the year 2017, a 2035 TDF may be chosen by an investor with approximately 20 years until her targeted retirement date. In concept, this investor would be able to allocate her entire existing retirement savings balance and any future contributions to a single 2035 TDF. In this example, an investor may also elect to allocate her retirement savings into two funds – 60% into a 2035 TDF and 40% into a 2040 TDF. As touted, an investor may only need to reallocate (to other TDFs) if she changes her target retirement date.
3. *See* "How America Saves 2016: Vanguard 2015 Defined Contribution Plan Data," Vanguard, June 2016, p. 54, accessed March 29, 2017, pressroom.vanguard.com/nonindexed/HAS2016_Final.pdf (How America Saves 2016).
4. "2017 Investment Company Fact Book," 57th edition, Investment Company Institute, Figure 7.20, "IRA Asset Allocation Varied with Investor Age" and Figure 7.25, "Target Date and Lifestyle Mutual Fund Assets by Account Type," pp. 155 and 161, accessed June 15, 2017, www.ici.org/pdf/2017_factbook.pdf.
5. As with any U.S. open-end mutual fund, objectives and constraints of the fund are described in the offering documents.
6. Some TDFs only adjust fund allocations up "to the target date," while others adjust allocations "through the target date."
7. In recent years, DC plan sponsors, often through their recordkeeping firms, have begun offering a range of advice programs from online advice, to managed accounts, to broad financial planning.
8. Managing solely to the target date is especially true in the case of off-the-shelf mutual fund TDFs that have no specific customization.
9. "Figure 1: Accumulation and Decumulation" review assumptions: We assume an annual Rate of Return of 4.1% for the fund. We assume the individual saves $2,000 at age 22 and that their annual savings increase by $300 each year while working (i.e. the individual saves $2,300 in their second year of working). We assume the individual retires at age 65. We assume that the individual withdraws $30,000 in their first year of retirement and that their annual withdrawal increases by $2,000 each year until they die at age 90 (i.e. they withdraw $32,000 in their second year of retirement). There is $30,179 left in the individual's retirement account when they die.
10. The underlying assumption is that an investor controls the length of the accumulation phase setting aside unexpected events outside her control like involuntary unemployment, health issues, or other emergencies.
11. In theory, it is possible to construct TDFs that target the length of both an investor's accumulation period and decumulation period. For example, a "2035/2045 TDF" could represent a target retirement date of 2035 with a 10 year life expectancy after retirement, whereas a "2035/2065 TDF" would allocate for a 30 year life expectancy. Of course, introducing a life expectancy assumption would significantly increase complexity and fund costs and could increase potential litigation risk.
12. Hans Erickson and John Cunniff, "'To' Versus 'Through': The Great Glidepath Debate," TIAA Global Asset Management, August 2016, p. 2, accessed May 19, 2017, www.nuveen.com/Home/Documents/Default.aspx?fileId=67237.
13. *Ibid*.
14. *Id*. at 4 (specifying savings assumptions including "Begin working/saving at age 30; retire at age 65; 30-year retirement period (to age 95)").
15. *See*, e.g., "Vanguard Target Retirement Fund Prospectus," Vanguard, January 27, 2017, p. 38, accessed May 19, 2017, personal.vanguard.com/pub/Pdf/p308.pdf (The Fund is designed for an investor who plans to withdraw the value of an account in the Fund over a period of many years after the target year.).
16. *See*, e.g., "Industry's First Target-Date Fund Celebrates 15 Years Since Groundbreaking Launch," Barclays Global Investors press release, November 7, 2008, accessed May 19, 2017, at www.marketwired.com/press-release/industrys-first-target-date-fund-celebrates-15-years-since-groundbreaking-launch-918094.htm (discussing the first TDFs introduced in November 1993 as "LifePath Portfolios").
17. *See*, e.g., "Target-Dates Top $1 Trillion, Yet Remain Largely Out of Reach for Most Asset Managers," Sway Research press release, March 22, 2016, accessed April 2, 2017, static1.squarespace.com/static/5661aba4e4b0c3b0ea70a07a/t/56f3ee4f20c647752991f97b/1458826848955/State_of_T-D_Market_Mar_2016.pdf.
18. Jeff Holt *et al.*, "2017 Target-Date Fund Landscape," Morningstar, April 20, 2017, p. 1.
19. "Retirement Assets Total $25.3 Trillion in Fourth Quarter 2016," Investment Company Institute, March 22, 2017, accessed June 15, 2017, www.ici.org/research/stats/retirement/ret_16_q4 and "2017 Investment Company Fact Book," 57th edition, Investment Company Institute, Figure 7.25, "Target Date and Lifestyle Mutual Fund Assets by Account Type," p. 161, accessed June 15, 2017, www.ici.org/pdf/2017_factbook.pdf.
20. *See generally*, How America Saves 2016. *See also* "The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2014," BrightScope and Investment Company Institute, December 2016, p. 7, accessed February 6, 2017, www.ici.org/pdf/ppr_16_dcplan_profile_401k.pdf (In 2014, the average 401(k) plan offered 28 investment options, of which about 14 were equity funds, four were bond funds, and seven were target date funds, based on analysis of the audited Form 5500 reports in the BrightScope Defined Contribution Plan Database for nearly 30,000 401(k) plans. Nearly all plans offered at least one equity and bond fund, and about three-quarters of plans offered a suite of target date funds.). *See also, Id.* at Exhibit 2.11, p. 40.

21. *See* How America Saves 2016, Figure 72, "Participant use of target-date funds," p. 66.

22. *Ibid.*

23. *See* "PSCA Releases Results of 59th Annual Survey of Profit Sharing and 401(k) Plans," PCSA press release, December 19, 2016, accessed May 19, 2017, www.psca.org/psca-releases-results-of-59th-annual-survey-of-profit-sharing-and-401-k-plans. "PSCA's 59th Annual Survey reflects the 2015 plan-year experience of 614 DC plan sponsors." According to this press release, TDF assets (which made up 19.8% of respondents' 401(k) assets) were second only to "actively managed domestic equity index funds," which comprised 21.4% of respondents' 401(k) assets.

24. *See* "PSCAs Annual Survey Shows Company Contributions are Bouncing Back," PCSA press release, October 11, 2012, accessed May 22, 2017, www.psca.org/psca-s-annual-survey-shows-company-contributions-are-bouncing-back.

25. *See* How America Saves 2016, Figure 51, "Plan asset allocation summary," p. 49.

26. *Id.* at Figure 52, "Plan contribution allocation summary," p. 50.

27. *See*, e.g., "Customization Comes to Target-Date Funds," *CPA Client Bulletin*, September 2016, accessed February 6, 2016, www.danielratliff.com/wp-content/uploads/2016/11/AICPA-Client-Newsletter-September-2016.pdf; *see also* Robert Steyer, "Cerulli: Target-Date Funds Snagging Larger Share of 401(k) Assets," *Pensions & Investments*, November 24, 2014, accessed May 22, 2017, www.pionline.com/article/20141124/ONLINE/141129936/cerulli-target-date-funds-snagging-larger-share-of-401k-assets.

28. *See* "Report: The US Retirement Market, Fourth Quarter 2016," Investment Company Institute, March 22, 2017, Table 5, "Defined Contribution Plan Assets by Type of Plan," accessed June 15, 2017, www.ici.org/info/ret_16_q4_data.xls.

29. *Id.* at Table 7, "IRA Assets by Type of Institution."

30. *See* 29 CFR § 2550.404c-5 (Fiduciary relief for investments in qualified default investment alternatives).

31. Only two other types of investments are deemed default investments, where unallocated funds can be directed and invested indefinitely. *See*, e.g., DOL Employee Benefits Security Administration, "Automatic Enrollment 401(k) Plans for Small Businesses," November 2013, p. 5, accessed May 22, 2017, www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/faqs/addingautoenroll.pdf.

32. Employee Retirement Income Security Act of 1974, Public Law 93-406, 88 Stat. 829.

33. Automatic enrollment for 401(k) plans has existed since at least the 1990s and has become increasingly more common in recent years since the passage of the PPA 2006, which encourages the use of automatic enrollment in 401 (k) plans. It is not uncommon that employee DC plan investors, particularly auto-enrollees, fail to specify an investment allocation, leaving them with the default allocation and contribution rates set by the sponsor. See Jack VanDerhei, "The Impact of Automatic Enrollment in 401(k) Plans on Future Retirement Accumulations: A Simulation Study Based on Plan Design Modifications of Large Plan Sponsors," Employee Benefit Research Institute, No. 341, April 2010, pp. 4 and 6, accessed August 2, 2017, www.ebri.org/pdf/briefspdf/EBRI_IB_04-2010_No341_Auto-Enroll1.pdf. "Employers can choose to automatically enroll employees in 401(k) plans, choosing a default initial contribution rate and a default investment, unless the employee indicates otherwise." *See* "The BrightScope/ICI Defined Contribution Plan Profile: A Close Look at 401(k) Plans, 2014," BrightScope and Investment Company Institute, December 2016, pp. 17-18, accessed February 6, 2017, www.ici.org/pdf/ppr_16_dcplan_profile_401k.pdf. According to Aon Hewitt, in 2010 approximately 57% of DC plans automatically enrolled new employees, up from 24% in 2006. *See* "2011 Hot Topics in Retirement: A Changing Horizon," Aon Hewitt, p. 10, accessed April 2, 2017, www.aon.com/attachments/thought-leadership/2011%20Hot%20Topics_Final.pdf.

34. *See* How America Saves 2016, p. 58.

35. *Ibid.*

36. *See* "How America Saves 2014: A Report on Vanguard 2013 Defined Contribution Plan Data," Vanguard, June 2014, Figure 1, "Highlights at a glance," p. 6, accessed June 20, 2017, institutional.vanguard.com/iam/pdf/HAS14.pdf.

37. *See*, e.g., "Investor Comprehension and Usage of Target-Date Funds: 2010 Survey," Vanguard, January 2011, accessed May 22, 2017, personal.vanguard.com/pdf/s204.pdf.

38. Jeff Holt *et al.*, "2017 Target-Date Fund Landscape," Morningstar, April 20, 2017, Exhibit 4, "2016 Target-Date and Firm Assets and Net Flows," p. 10.

39. *Id.* at Exhibit 5, "2016 Firm Market Share of Target-Date Mutual Funds," p. 11 and Josh Charlson *et al.*, "Target-Date Series Research Paper: 2009 Industry Survey," Morningstar, September 9, 2009, "Net Assets, Target-Date Funds, in $ millions," p. 5.

40. "Target-Dates Top $1 Trillion, Yet Remain Largely Out of Reach for Most Asset Managers," Sway Research press release, March 22, 2016, accessed April 2, 2017, static1.squarespace.com/static/5661aba4e4b0c3b0ea70a07a/t/56f3ee4f20c647752991f97b/1458826848955/State_of_T-D_Market_Mar_2016.pdf; *see also* "TDFs Top $1 Trillion, Still Concentrated," NAPA Net, March 23, 2016, accessed May 22, 2017, www.napa-net.org/news/managing-a-practice/industry-trends-and-research/tdfs-top-1-trillion-still-concentrated/; Rebecca Moore, "TDF Mutual Funds and CITs Dominated by Proprietary Holdings," *Plan Sponsor*, March 22, 2016, accessed July 21, 2017, www.plansponsor.com/TDF-Mutual-Funds-and-CITs-Dominated-by-Proprietary-Holdings/.

41. *See*, e.g., 2010 Fund in "Vanguard Target Retirement Funds Prospectus," Vanguard, January 27, 2017, p. 14, accessed March 31, 2017, www.vanguard.com/pub/Pdf/p308.pdf. Similar language appears in the same prospectus for funds with different target dates.

42. In terms of corporate capital structure, bonds payments have priority above equity.

43. Despite the baseline points, it should be clear that not every portfolio with "less equity" should be considered less risky than one with "more equity" and vice versa.

44. James M. Poterba *et al.* report that "[a]t modest levels of risk aversion, or when the household has access to substantial non-401(k) wealth at retirement, the historical pattern of stock and bond returns implies that the expected utility of an all-stock investment allocation rule is greater than that from any of the more conservative strategies." James M. Poterba, Joshua Rauh, Steven F. Venti, and David A. Wise, "Life-cycle Asset Allocation Strategies and the Distribution of 401(k) Retirement Wealth," in *Developments in the Economics of Aging*, ed. David A. Wise (Chicago: University of Chicago Press, March 2009), p. 48, accessed July 12, 2017, www.nber.org/chapters/c11308.pdf. Robert Shiller observes that "the results are disappointing for the life cycle portfolios, especially when we use the more realistic assumption about future returns that they should match world experience rather than the experience of the U.S. One is tempted to say that workers should eschew the life cycle portfolio altogether, and participate only in the 100% stocks portfolio." Robert J. Shiller, "The Life-Cycle Personal Accounts Proposal for Social Security: An Evaluation," NBER Working Paper No. 11300, April 2005, p. 24, accessed July 11, 2017, aida.wss.yale.edu/~shiller/pubs/nber11300.pdf.

45. *See* Edwin J. Elton, Martin J. Gruber, Andre de Souza, and Christopher R. Blake, "Target Date Funds: Characteristics and Performance," *Review of Asset Pricing Studies* 5(2) (December 2015): 258-260.

46. *Ibid.*

47. *See* "TIAA-CREF Lifecycle Funds: Methodology and Design," TIAA Global Asset Management, 2017, Exhibit 1, "TIAA-CREF Lifecycle Funds Glidepath," p. 2, accessed May 22, 2017, www.nuveen.com/Home/Documents/Default.aspx?fileId=67235.

48. Edwin J. Elton, Martin J. Gruber, Andre de Souza, and Christopher R. Blake, "Target Date Funds: What's Under the Hood?," Center for Retirement Research at Boston College, 17(2) (January 2017), p. 2, accessed May 22, 2017, crr.bc.edu/wp-content/uploads/2017/01/IB_17-2.pdf.

49. *Id.* at endnote 8, p. 6.

50. "Decoding Target Date Fund Design," J.P. Morgan Asset Management, February 2014, p. 6, accessed May 22, 2017, am.jpmorgan.com/blobcontent/1383175812596/83456/RI_Decoding-TDF-Design-Brochure.pdf.

51. Stephen J. Brown, Greg N. Gregoriou, and Razvan C. Pascalau, "Diversification in Funds of Hedge Funds: Is It Possible to Overdiversify?," July 7, 2011, accessed July 12, 2017, papers.ssrn.com/sol3/papers.cfm?abstract_id=1436468.

52. "Fact Sheet: Morningstar Target-Date Fund Series, Rating and Research Reports," Morningstar, 2009, p. 1, accessed June 15, 2017, admainnew.morningstar.com/directhelp/FactSheet_TargetDateRating.pdf.

53. *See,* e.g., Dynamic Target Date Funds Prospectus for Class R6, Wells Fargo Asset Management, October 1, 2016, p. 22, accessed May 23, 2017, www.wellsfargofunds.com/assets/edocs/regulatory/prospectus/dynamic-target-date-r6-pro.pdf. (At their discretion, the Fund's portfolio managers may make changes to the Fund's asset allocation. At any point, as a result of the utilization of the futures overlay and changes otherwise implemented by the portfolio managers, there may be significant divergences between the effective asset allocation of the Fund and its strategic target allocation.)

54. *See* "TIAA-CREF Lifecycle Funds: Methodology and Design," TIAA Global Asset Management, 2017, p. 16, accessed May 22, 2017, www.nuveen.com/Home/Documents/Default.aspx?fileId=67235.

55. *See,* e.g., Robert G. Ibbotson and Paul D. Kaplan, "Does Asset Allocation Policy Explain 40, 90, or 100 Percent of Performance?" *Financial Analysts Journal* 56(1) (January/February 2000): 26-33, accessed July 12, 2017, www.mangustarisk.com/doc/pdf/Does_Asset_Allocation_Explain_40_90_100_Performance.pdf.

56. *See,* e.g., "Fiduciary Responsibilities," U.S. Department of Labor, accessed May 23, 2017, at www.dol.gov/general/topic/retirement/fiduciaryresp. (Fiduciary duties are owed under ERISA by "persons or entities who exercise discretionary control or authority over plan management or plan assets, anyone with discretionary authority or responsibility for the administration of a plan, or anyone who provides investment advice to a plan for compensation or has any authority or responsibility to do so are subject to fiduciary responsibilities" including "plan trustees, plan administrators, and members of a plan's investment committee.")

57. *See* ERISA § 404(a)(1)(B), codified at 29 U.S. Code § 1104(a)(1)(B).

58. *See* U.S. Department of Labor, Employee Benefits Security Administration, Advisory Opinion 2009-04A, December 4, 2009, p. 2, accessed June 6, 2017, www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/advisory-opinions/2009-04a; *see also* Wagner Law Group, "Fiduciary Guidebook for Target Date Funds," Legg Mason Global Asset Management, 2011, p. 4, accessed May 23, 2017, www.wagnerlawgroup.com/documents/WPFiduciaryGuidebooktoTDFs.pdf.

59. *See* U.S. Department of Labor, Employee Benefits Security Administration, "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries," February 2013, accessed May 23, 2017, www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/fsTDF.pdf.

60. U.S. Department of Labor, Employee Benefits Security Administration, "Target Date Retirement Funds – Tips for ERISA Plan Fiduciaries," February 2013, p. 2, accessed May 23, 2017, www.dol.gov/sites/default/files/ebsa/about-ebsa/our-activities/resource-center/fact-sheets/fsTDF.pdf.

61. Carmen Germaine, "SEC Muddies Fiduciary Rule Waters With Comment Request," *Law360*, June 7, 2017, accessed June 20, 2017, www.law360.com/banking/articles/932214/sec-muddies-fiduciary-rule-waters-with-comment-request.

62. "General Information on the Regulation of Investment Advisors," U.S. Securities and Exchange Commission, March 11, 2011, accessed July 17, 2017, www.sec.gov/divisions/investment/iaregulation/memoia.htm.

63. "2017 Investment Company Fact Book," 57th edition, Investment Company Institute, Figure 7.25, "Target Date and Lifestyle Mutual Fund Assets by Account Type," p. 161, accessed June 15, 2017, www.ici.org/pdf/2017_factbook.pdf.

64. Lisa Beilfuss, "'Fiduciary' Rule Accelerates Account Shift Across Brokerage Industry," *The Wall Street Journal*, July 19, 2017, accessed July 27, 2017, www.wsj.com/articles/fiduciary-rule-accelerates-account-shift-across-brokerage-industry-1500494055.

65. Complaint, ¶ 9, *Jacobs v. Verizon Comm., Inc.*, No. 16-cv-01082 (S.D.N.Y. February 11, 2016).

66. *Id.* at ¶¶ 9-10.

67. *Id.* at ¶ 14.

68. *Id.* at ¶¶ 17-18.

69. *Id.* at ¶¶ 99-101, 120.

70. *Id.* at ¶¶ 102-104.

71. Complaint, ¶¶ 1-2, *Meiners v. Wells Fargo & Co.*, 2017 U.S. Dist. LEXIS 80606 (D. Minn. May 25, 2017) (No. 16-cv-03981).

72. *Ibid.*

73. *Id.* at ¶ 3.

74. *Meiners v. Wells Fargo & Co.*, 2017 U.S. Dist. LEXIS 80606 (D. Minn. May 25, 2017).

75. Notice of Appeal, *Meiners v. Wells Fargo & Co.*, No. 17-cv-02397 (8th Cir. June 23, 2017).

76. See Consolidated Complaint, ¶ 1, *Sulyma v. Intel Corp. Inv. Policy Comm.*, 2017 U.S. Dist. LEXIS 49788 (N.D. Cal. Mar. 31, 2017) (No. 15-cv-04977).

77. *Id.* at ¶¶ 4-6.

78. *Id.* at ¶¶ 8-13.

79. Motion to Dismiss, p. 2, *Sulyma v. Intel Corp. Inv. Policy Comm.*, 2017 U.S. Dist. LEXIS 49788 (N.D. Cal. Mar. 31, 2017) (No. 15-cv-04977).

80. *Id.* at Memorandum of Points and Authorities, p. 1.

81. *Ibid.*

82. *Sulyma v. Intel Corp. Inv. Policy Comm.*, 2017 U.S. Dist. LEXIS 49788 (N.D. Cal. Mar. 31, 2017).

83. Confirmation of Receipt of Notice of Appeal, *Sulyma v. Intel Corp. Inv. Policy Comm.*, No. 17-cv-15864 (9th Cir. Apr. 27, 2017).

84. *Tussey v. ABB, Inc.*, 746 F.3d 327 (8th Cir. Mar. 19, 2014).

85. *Id.* at 341.

86. *See Tussey v. ABB, Inc.*, 2012 U.S. Dist. LEXIS 45240 at *27-28 (W.D. Mo. Mar. 31, 2012) (No. 06-cv-04305), *aff'd in part,* 746 F.3d 327 (8th Cir. 2014).

87. *Id.* at *29.

88. *Id.* at *106-108.

89. *Tussey v. ABB Inc.*, 2015 U.S. Dist. LEXIS 89068 (W.D. Mo. July 9, 2015) (No. 06-cv-04305).

90. *Tussey v. ABB, Inc.*, 850 F.3d 951, 954, 962 (8th Cir. Mo. Mar. 9, 2017).

ABOUT THE BRATTLE GROUP

Our economic experts, including renowned academics and industry specialists, possess deep expertise in finance, capital markets, and asset management, including regulatory work and industry custom and practice.

Our experts include former senior staff of large financial institutions, as well as former regulators and senior government officials, allowing us to provide our clients with detailed, real-world knowledge of how various financial institutions actually operate.

Our experience spans a range of engagements involving appropriateness of portfolio management strategies, broker/client investment suitability and foreseeability, customer trading and fees, risk management, mutual fund market practices, and analysis of price impact and damages. Understanding that broker-dealers' duties and responsibilities are constantly challenged in both a contractual and fiduciary role, Brattle experts knowledgeably analyze broker-dealer operations and explain complex products, disclosure requirements, valuation, damages, and a myriad of other issues.

For additional information about The Brattle Group's experts and services, please visit **brattle.com**.

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INTRODUCTION

The Brattle Group's securities litigation experts provide testimony on economics, finance, banking, accounting, regulation, and industry custom and practice. Our principals and academic advisors have wide-ranging academic qualifications and industry experience. We also draw on a broader network of leading academic and industry experts to meet the needs of particular cases.

Some of the noteworthy cases we have worked on include:

- *Starr v. US* takings action
- Lehman bond class action
- *Barclays v. Bear Stearns* litigation
- *Syncora v. Countrywide RMBS* litigation
- Flagstar mortgage put-back case
- Madoff feeder fund cases
- LIBOR benchmark litigation
- CDS market foreclosure investigation
- Tribune fraudulent conveyance case
- Yukos valuation dispute

Our expertise in this area includes:

- Securities Class Actions
- Financial Markets Regulation and Banking Disputes
- Market Microstructure, Trading Abuse, and Market Manipulation
  - Wholesale Financial Market Conduct Disputes
  - Commodity Market Trading and Market Manipulation
- Issues of Industry Custom And Practice
- Derivatives and Risk Management
  - Derivatives, Closeout Disputes, and Risk Analysis
  - Risk Management and Hedging Strategies
- Suitability and Mis-selling Cases
- White Collar Investigations and Litigation
- Mortgage Related and Securitization
- Valuation
  - Valuation of Securities, Financial Interests, and Business Operations
  - Minority Shareholder, M&A and Post-Merger Disputes
- Financial Distress, Bankruptcy, and Fraudulent Conveyance

SECURITIES CLASS ACTIONS

The Brattle Group has provided expert testimony in all phases of Rule 10b-5 and Section 11 and 12 claim matters. We have substantial experience concerning analyses of loss causation, market efficiency, and trading behavior to support successful arguments on class certification. We work with clients during the early phase of securities class actions and help to evaluate whether or not a case should proceed. At the class certification phase, our experts can assist clients in

determining whether the securities traded in an efficient market, the evidence of price impact and the extent of conflicts among class members. Using well-developed arguments and approaches to evaluate per-share damages scenarios, we are able to help clients assess potential liability. Additionally, depending on the issues, we may be able to identify economic arguments in favor of or against defendant liability. Our staff and affiliated experts have developed innovative methods involving issues of class certification, loss causation, and damages in numerous cases across a wide range of industries.

Using plaintiff-style damage calculation methodologies, we help our clients early on when a case gets started. It is also common for our clients to ask us to estimate the exposure and the amount defendants are likely to pay if the case settles.

Impact of Accounting Misstatements: In litigation involving a privately held software company being acquired in a stock transaction by a larger, publicly held software company, we calculated economic damages as a result of the acquisition being transacted at an artificially inflated stock price. The defendant, a large public accounting firm, was alleged to have failed in its duties to the public markets because of disregard for Generally Accepted Auditing Standards (GAAS), Generally Accepted Accounting Principles (GAAP), and other misrepresentations. Our analysis estimated the impact that specific accounting misstatements had on auditing negligence on the public accounting firm's part, and calculated the relevant stock price "but for" these misstatements.

Liability and Loss Causation in Lehman Bond Class Action: Brattle experts analyzed the financial performance of Lehman during 2008 and in particular the decline in its bond prices and increase in CDS spreads. The factors that posed ex ante concerns to investors were compared to the risks, the realization of which resulted in Lehman's default. Disclosures made by Lehman in its bond offering documents were assessed to determine whether relevant information was omitted. The alleged omissions were not found to have been a cause of investors' losses. Investors were found to have relied on their belief in continuing government support which was not forthcoming. Communications between Lehman and the members of its underwriting syndicate were evaluated and underwriters found to have conducted themselves in accordance with normal custom and practice.

Materiality of Inventory Overstatements: The Brattle Group analyzed the financial impact of inventory overstatements in a securities fraud case in the health care industry. Our analysis demonstrated that inventory misstatements were an inconsequential part of the overall scheme of the fraud, and that they did not cause material artificial inflation in the stock price or material damage to shareholders.

Damages Estimation: In securities litigation for a national managed care provider, we analyzed economic loss causation, modeled various damage scenarios, and provided a critique of the defendant's expert reports. Our work assisted counsel for the class in preparing for settlement negotiations. The case settled for $300 million.

FINANCIAL MARKETS REGULATION AND BANKING DISPUTES

Takings Case Involving the Terms of Government Financial Assistance to AIG: In *Starr v. US*, Brattle principal Dr. Cragg developed expert testimony on the conduct of the FED in acting as lender of last resort to systemically important financial institutions as the financial crisis developed in 2008. This analysis examined the historical uses of Section

13(3) of the Federal Reserve Act and the differences in treatment of institutions that were provided assistance in response to the crisis. The various actions of the Federal Reserve were explained in the context of the structure of the US financial markets, the role of the shadow banking system and how a combination of factors precipitated a run in the repo system as market liquidity collapsed.

Bank Director Professional Liability Litigation: Brattle experts assisted an excess D&O insurer in connection with the defense of a professional liability claim against the directors and officers of a failed bank. The directors and officers were alleged to have mismanaged to bank resulting in negligent underwriting practices, which through the credit crisis produced loan losses for which the FDIC claimed damages. The Brattle Group evaluated the performance of the bank compared to its peers to assess causation and damages.

Irish Regulatory Response to the Financial Crisis: In a case challenging the legitimacy of the Irish government's response to that country's banking crisis, Eugene F. Collins, Solicitors at Law in Ireland, engaged Brattle principal Dr. Cragg and Nobel prize winning economist Dr. Joseph Stiglitz to provide economic support for an appeal on behalf of their client, Paddy McKillen. The appeal aimed to prevent the Irish state agency NAMA from seizing €2.1 billion in loans that were secured by an extensive portfolio of commercial properties owned by Mr. McKillen, a leading Irish investor. The appeal was successful and a seven judge court unanimously ruled that NAMA made no valid decision in December 2009 – or since then – to acquire Mr. McKillen's loans. The firm had also retained Dr. Stiglitz, Dr. Cragg, and Brattle principal Mr. Joseph Belanger to evaluate whether the agency's seizure of the McKillen loans was economically appropriate, given Irish economic conditions and the condition of the McKillen loans themselves. According to an article in the Irish Times, legal sources believe that the impact of this court decision is that NAMA will need to start the entire process again if it still wants to acquire the loans.

MARKET MICROSTRUCTURE, TRADING ABUSE, AND MARKET MANIPULATION

In alleged trading abuse, market manipulation and wholesale market conduct disputes, The Brattle Group provides the valuable combination of financial markets knowledge of practices and regulation; financial economics skills; risk analytics; big data capabilities, and antitrust experience. This expertise is used to distinguish potentially manipulative activity such as uneconomic trading, spoofing, collusion or fraud from legitimate trading practices and hedging activities in often imperfect, opaque and illiquid markets. Brattle experts include former regulators, and market practitioners. We also draw on outside specialists with specific industry experience and top academics in the specialized topics increasingly involved.

We are well-versed in the anti-manipulation rules of the Securities and Exchange Commission (SEC), Federal Energy Regulatory Commission (FERC), Commodity Futures Trading Commission (CFTC), and Federal Trade Commission (FTC), as well as equivalent rules in place in the European Union. We have also worked on manipulation cases brought pursuant to state laws or actions by the U.S. Department of Justice (DOJ). We provide clients with a holistic perspective concerning the types of behavior that these agencies may deem manipulative; one that is consistent with past enforcement outcomes and current enforcement cases.

WHOLESALE FINANCIAL MARKET CONDUCT DISPUTES

LIBOR Benchmark Manipulation Litigation: The Brattle Group is providing economic analysis in connection with class action litigation, and supporting academic economists in developing expert opinions concerning the effects of alleged LIBOR benchmark manipulation.

Analysis of Alleged FX Standing Instruction Misstatements: The Brattle Group worked on a case involving "best execution" of FX trades, in connection with allegations that a major bank fraudulently misled customers in its Standing Instruction (SI) program. Brattle's role includes extensive data analysis and support for a testifying expert to analyze damages claims.

EC Investigation of Alleged Collusion and Exclusionary Conduct in CDS Trading: During 2012-2013 Brattle was retained by a global investment bank as part of an EC investigation brought against twelve dealer banks regarding alleged collusion and exclusionary conduct in the global market for trading credit default swaps (CDS). We were retained to evaluate the maturity and liquidity of the CDS market to determine its preparedness for migration from OTC to a liquid all-to-all (CLOB) exchange-based trading platform. We also evaluated the EC hypothesis that bid-ask spreads would have been narrower under exchange-based trading.

COMMODITY MARKET TRADING AND MARKET MANIPULATION

Amaranth Advisors/Brian Hunter Natural Gas Attempted Manipulation: The Brattle Group was engaged to conduct economic analyses in connection with allegations that Amaranth Advisors and its head natural gas trader, Brian Hunter, attempted to manipulate settlement prices of NYMEX futures contracts for delivery of natural gas to the Henry Hub. The alleged manipulation occurred during the months of February, April, and May of 2006.

Internal Investigation of Suspicious Trading Activity: The Brattle Group assisted a large physical market participant in assessing its potential liability with respect to specific trading strategies that potentially altered the value of related physical index and financial derivatives positions. We performed this analysis in cooperation with the client's external counsel to provide a clear, consistent understanding of the behavior that could be of concern and meaningful perspectives as to how the client could improve compliance on a go-forward basis.

Agency Self-Report: The Brattle Group successfully assisted a major financial trading organization in preparing and submitting a self-report concerning legitimate trading behavior that might have been misconstrued as manipulative. The analysis provided was consistent with the logic of an analytic framework developed and published by several Brattle economists. The agency decided to take no action against the market participant in this case.

Support of Client under Investigation: The Brattle Group assisted a commodity trader's preparation for deposition pursuant to an investigation for alleged manipulative activity. Using market data, the client's trading book, documents provided by the government, and objective data including IMs, emails and public data surrounding the suspected trade events, The Brattle Group evaluated the government's likely "best case" that could be brought against the trader, as well as potential "best responses" the trader would have in response to refute the causal elements necessary to prove manipulative intent.

Uneconomic Trading by Energy Transfer Partners (ETP): The Brattle Group was engaged as consulting and testifying experts by the Office of Enforcement of the FERC in connection with allegations that ETP manipulated wholesale natural gas prices at the Houston Ship Channel. An expert with The Brattle Group provided testimony and direct support for the FERC's Order to Show Cause. The case alleged manipulation of a natural gas index through the use uneconomic fixed-price trades to the benefit of financial derivatives and physical index positions tied to that index.

Alleged Manipulation of Physical Market to Benefit Derivative Positions of Constellation Energy Commodities Group (CECG): We provided an analytic framework for evaluating CECG's allegedly uneconomic use of virtual and physical power transactions to benefit the value of financial transmission rights and other financial derivatives. The case settled in 2012. The framework used for this analysis has been generalized to describe manipulative behavior, and is used as a tool to assist clients in anti-manipulation compliance efforts.

ISSUES OF INDUSTRY CUSTOM AND PRACTICE

Custodial Duties in Madoff Dispute: In a case before the High Commercial Court in Dublin, Brattle supported an expert in due diligence duties and responsibilities in the selection and monitoring of sub-custodians.

Economics Analysis of Stock Lending Practices: Lehman claimed foreign tax credits of nearly $500 million stemming from stock lending transactions. The IRS denied these credits and Lehman's bankruptcy estate sued the U.S. government to recover these credits. Brattle principal Dr. Michael Cragg evaluated the business purpose of the transactions giving rise to the tax credits. Dr. Cragg also evaluated the profitability of these transactions with and without the claimed tax credits and compared these transactions to Lehman's other stock borrowing and lending activity with respect to frequency, timing, size, duration, profit margin, counterparty, method of collateralization and other characteristics.

Repo Market Margin Call Custom and Practice: On behalf of Barclays Capital in a disputed margin call brought the bankruptcy trustee of Thornburg Mortgage, Brattle experts provided damages testimony and supported an expert in Master Repurchase Agreement custom and practice.

Valuation of Pension Obligations: For the plaintiff in litigation over the sale of a group of companies and the attendant default on pension obligations, The Brattle Group performed analyses of financial statements and business plans, and developed discounted cash flow valuations for each of the transferred units. We used option valuation techniques to characterize the components of the contracts and examined interactions with other corporate units in an option pricing framework. We also recruited and coordinated five testifying experts. Our testimony spanned a variety of areas including damages, accounting issues, business practices, and pension valuation inputs.

DERIVATIVES AND RISK MANAGEMENT

The Brattle Group provides consulting and expert testimony on the theory, valuation, use, and regulation of derivatives. The Brattle Group's staff and affiliates include professors and former practitioners in risk management and derivatives; specifically: a Nobel Prize winning economist, a former director of risk management at a large broker-

dealer, and an author of a leading graduate level textbook on risk management and derivatives. We regularly work in collaboration with industry experts including former traders, risk managers and compliance professionals.

The range of derivatives instruments we are retained to analyze and value is wide and can be originated and traded a number of different ways: exchange-traded like a futures contract, over-the-counter as a counter party's obligation (such as a swap), publicly offered as a trust-issued claim against the trust's own assets like a collateralized mortgage obligation (CMO), or a hybrid instrument such as a synthetic collateralized debt obligation (CDO) sold as a 144A private placement. Our analysis often concerns how derivatives were used and whether for reducing financial risk through hedging or for taking risk as part of an investment strategy. The Brattle Group experts analyze the economic value and performance of instruments in terms of the underlying assets, payment conditions, and trading venue. They also evaluate suitability and performance of derivatives whether used as investments or to hedge.

DERIVATIVES, CLOSEOUT DISPUTES, AND RISK ANALYSIS

Role of Derivatives in Hedge Funds Collapse: On behalf of an investor in a failed hedge fund, The Brattle Group applied financial pricing theory to value derivative instruments whose values were tied to the performance of underlying asset portfolios, including CDOs, CDOs-squared, and credit default swaps. We analyzed the fund's investment decisions, compliance with the investment guidelines, and performance reporting.

Hedging Interest Rate Exposure of Accounts Receivables: The Brattle Group evaluated the economic performance of a series of Treasury security short-sales purportedly used to hedge changes to the value of an accounts receivable portfolio as interest rates varied.

Total Return Swap Market-to-Market Dispute: In a dispute between a hedge fund and a major bank, The Brattle Group was retained to analyze the marking to market and eventual liquidation of a portfolio of syndicated loans underlying a total return swap. We worked with a former loan trader to discuss the liquidity of the secondary loan market in the aftermath of the Lehman Brothers bankruptcy filing, evaluate the reasonability of the bank's method of marking to market the portfolio assets and of liquidating the loan portfolio through a BWIC auction, and estimate the market value the loan portfolio.

Repo Market Margin Call Valuation Dispute: The Brattle Group has been retained to provide expert testimony in a dispute between an investment fund and a major broker-dealer involving the repo financing of a multi-billion dollar portfolio of mortgage-backed securities. Our experts evaluated the procedure followed by the broker-dealer to issue margin calls and handle valuation disputes in light of market practice and the provisions of the Master Repurchase Agreement, evaluated the marking to market and eventual liquidation of the MBS portfolio, and calculated damages from the early termination of the repo financing arrangements.

Long Term Capital Trading and Valuation Analysis: The Brattle Group evaluated the structured finance transactions, business practices and trading strategies, including the use of derivatives, of Long Term Capital Management. This involved valuation of assets including securitized lease payments from computers, box cars, trucks, aircraft and telecommunication equipment, over-the-counter derivatives on liquid and illiquid instruments, and a private-placement transaction.

Foreign Currency Options Modeling: In connection with litigation, The Brattle Group applied option pricing theory in a scenario analysis to estimate the risks and likelihoods that foreign currency options would be exercised.

Derivatives Valuation and Disclosure Issues: The Brattle Group has assisted clients in litigation matters involving the proper application of mark-to-market and derivative accounting in the energy industry. Specifically, we provided litigation support in securities litigation matters regarding the valuation of energy contracts and the application of accounting principles to the proper disclosure of power derivatives and hedges.

RISK MANAGEMENT AND HEDGING STRATEGIES

Assessment of AIG's Risk Management: In Starr v. US, The Brattle Group evaluated the risk management practices of AIG prior to the credit crisis to evaluate the extent to which its risk controls and reporting were consistent with customary practices. A Brattle expert provided testimony evaluating AIG's management of its risk exposure to subprime mortgage defaults and the timing of its response to the increase in defaults prior to the credit crisis.

Optimization of Trading Strategies and Hedging: The Brattle Group has advised on all aspects of risk management techniques and hedging programs adopted by power companies. We have analyzed the efficiency of trading strategies and developed estimates of critical option valuation parameters, such as trend, volatility, term structure, and correlations of the future prices of electric power and the various fuel indexes. We have assessed the financial risks of energy company portfolios consisting of production facilities, purchase/sale contracts, and retail customers, and quantified the underlying price and volumetric and operational risk exposures.

Estimating Forward and Spot Market Pricing Models: The Brattle Group assisted several utilities in the development of valuation models for the comparison of ask prices to fair market values for option contracts. We has developed techniques for estimating forward and spot market price parameters on a consistent basis, which are then often used in risk management or valuations models.

SUITABILITY AND MIS-SELLING CASES

Leveraged Hedge Fund Portfolio Broker-Customer Dispute: The Brattle Group was retained to testify at a FINRA arbitration in relation to a failed leveraged hedge fund investment that was liquidated by the leverage provider following a knockout event during the credit crisis. An individual investor switched from a margin account to use an option contract structure to bet on the performance of a customized portfolio of hedge fund investments. The dispute concerned whether the structure was suitable and whether investor understood its operation and how it differed from a margin account. Testimony was developed in connection with causation and damages on differences in the operation of the option structure compared to a margin account; the effect of limitations on fund selection on performance; and how the knockout event was triggered.

Investor Suitability in Forward Contracts: In an investor suitability case, we estimated economic damages to an overseas feed and flour mill resulting from an alleged breach of fiduciary duty in the execution of grain forward

contracts. Reliance, arbitration, and lost profits damage theories were all evaluated. Our analysis drew on information from market conditions, firm-specific data, and the terms of the forward contracts in dispute.

WHITE COLLAR INVESTIGATIONS AND LITIGATION

Brattle's experience in white-collar investigations and litigation has included insider trading cases, regulatory enforcement matters involving alleged abusive business practices, market and trading abuses, misconduct by financial market institutions, Foreign Corrupt Practices Act (FCPA) violations, and money laundering. Our clients include major companies, financial institutions, investigative agencies such as the Federal Bureau of Investigations (FBI) and Secret Service, U.S. government regulators such as the Internal Revenue Service (IRS) and the Securities and Exchange Commission (SEC), private law firms, and the U.S. Department of Justice (DOJ).

Insider Trading SEC Administrative Action: A Brattle expert conducted a statistical analysis of trading patterns to assess whether particular trades were correlated with instances in which the defendant had access to inside information in the form of advance copies of analyst reports. The types of reports that were expected to have an effect on share price were evaluated with reference to the economic literature on stock price response to different types of disclosures in analyst reports.

Money Laundering Investigation.: Brattle experts are currently assisting the U.S. DOJ and FBI in an active investigation of potential money laundering in the U.S. by certain foreign banks. We have analyzed transaction data in bank correspondent account records to identify and profile certain characteristics of the transactions in question, including identifying possible omissions, misrepresentations, and/or false paperwork. The investigation may result in criminal charges.

False Claims Act case: U.S. v. Countrywide / BofA: In landmark litigation against a major U.S. financial institution under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), Brattle experts helped to identify and recruit multiple experts and advise counsel on case-specific facts and considerations from inception through trial. We coordinated rigorous review of millions of documents produced and used in discovery, as well as analysis of loan-level data to determine the information known about the quality of the loans in question, management's actions, the causes of loan defaults, and the extent of resulting damages. We assisted counsel in real-time before and during trial, which ended in a jury verdict favorable for the client on liability and a $1.3 billion damages award.

MORTGAGE RELATED AND SECURITIZATION

The Brattle Group has been retained as experts and has worked with academic economists in cases involving banks, hedge funds, other financial institutions including BofA, Countrywide, MBIA and the FDIC. The Brattle Group has worked closely with academics including Nobel Laureates Joseph Stiglitz and Daniel McFadden, Gary Gorton, and Dwight Jaffee. Our work has covered the following range of topics:

- statistical sampling of loan pools and assessment of compliance with prospectus
- analysis of mortgage underwriting and loan characteristics on loan performance
- investigation of alleged discrimination in mortgage lending

- evaluation of put-back liabilities of mortgage-back securities (MBS) issuers
- analysis of risk management and mortgage accounting practices
- mark-to-market pricing of thinly traded MBS
- investigation of potential abuses in trading practice and reporting

Loan Pool Sampling and Analysis: The Brattle Group has significant experience in the sampling and analysis of large and complex loan datasets. We have evaluated the characteristics of loans underlying the mortgage pools to understand the extent to which loan pools may have been concentrated in certain geographic areas, among certain types of borrowers, and with specific types of loans. These loan attributes include: the geographic distribution of collateral; seniority (e.g., first or second lien); LTVs or CLTVs; amortization schedule (e.g., fixed rate, ARM, Option ARM); and borrower creditworthiness.

Underwriting Loss Causation: In the case of *Syncora Guarantee Inc. v Countrywide Home Loans Inc.*, The Brattle group was retained by bond insurer Syncora to calculate the losses accrued as a result of securitized home equity loan defaults issued by Countrywide. Our experts assessed whether the defaults were primarily a result of housing market conditions or of loan defects that went undetected due to a failure by Countrywide to adhere to published mortgage underwriting guidelines. The case settled for $375 million during expert discovery.

Liability Issues in Put-Back Litigation: The Brattle Group was retained by outside counsel representing the Federal Deposit Insurance Corporation (FDIC) in litigation against several financial institutions over the issuance of faulty MBS to a bank now acquired by the FDIC. We assessed whether the FDIC or the issuing bank should be liable for the mortgage put-back obligations from the originator, and whether and how the transfer of the originator to the bank by the FDIC was affected by contingent put-back liabilities.

VALUATION

Valuation analysis is a substantial part of securities and financial markets litigation. The analysis used to value complex security instruments requires a thorough understanding of the facts and issues. To this end, The Brattle Group combines in-depth industry experience and rigorous analyses using sound economic and financial principles to help clients answer complex valuation and financial questions in litigation.

Valuation analysis is a common approach in disputes associated with bankruptcies, buyouts, divestitures, initial public offerings, going-private transactions, mergers and acquisitions, private placements, and reorganizations. Valuation analysis is also common in disputes that focus on debt, derivative securities, and intellectual property rights.

The Brattle Group's litigation experts have extensive experience with valuation analysis such as appraisal of fair value, estimation of cost of capital, and disputes associated with mergers and acquisitions. Our expertise is grounded in a thorough understanding of finance and economics, accounting, financial products, capital markets, regulation, and industry custom and practice.

VALUATION OF SECURITIES, FINANCIAL INTERESTS, AND BUSINESS OPERATIONS

Enterprise Valuation of a Telecommunications Company: On behalf of the special committee to the board of directors for a major international telecommunications provider in bankruptcy proceedings, The Brattle Group provided forensic analysis of the economics, financial reporting, and accounting associated with the company's bankruptcy. The engagement involved contemporaneous review and analysis of telecom market structure and trends, capacity and pricing projections in international markets, business justification of certain transactions, and appropriateness of the accounting for these transactions. The project also involved econometric event study analysis and the estimation of the impact of quarterly earnings announcements on equity prices and enterprise value.

Real Option Valuation Drug Development Business: The Brattle Group built real options models for the drug development process for 19 drugs in various stages of clinical progress. We valued the profit split on the potential returns of these drugs between small biotechnology firms and the large pharmaceutical firms with whom they entered into business alliances. We analyzed the terms of the development contracts and the assumptions on revenues, manufacturing costs, clinical trial expenses, cost of capital, and itemized income statement expenses.

MINORITY SHAREHOLDER, M&A, AND POST-MERGER DISPUTES

Valuation of Minority Shares: On behalf of an investment management company, we were retained to prepare expert testimony on valuation principles used to price privately held minority shares in a global financial institution with assets of about $150 billion. The majority shareholders of the institution forcibly repurchased the shares of the minority shareholders at a price determined by the board based on two valuation studies prepared for them. Our client, a large minority shareholder, filed a lawsuit against the institution based on the belief that the repurchase price undervalued the privately held shares. The arbitration panel ruled that the repurchase price did undervalue the privately held shares and ordered the institution to make additional payments equal to about fifty percent of the original repurchase price.

Material Adverse Change: We worked on behalf of a large, publicly held company in the energy sector involved in a breach of contract associated with an aborted merger transaction. We performed forensic accounting services and developed an economic analysis of material adverse change. Our experts also analyzed potential exposure related to allegations of violations of Rule 10b-5.

FINANCIAL DISTRESS, BANKRUPTCY, AND FRAUDULENT CONVEYANCE

Impact of Financing Strategy on Alleged Deepening Insolvency: In a number of litigations against Bank of America in Parmalat's bankruptcy, The Brattle Group advised counsel for Bank of America regarding a number of structured finance transactions it arranged for Parmalat's Latin American subsidiaries. We supported Professor René Stulz to provide a coherent framework to examine a multinational enterprise's management of its financing strategy in the emerging markets. Against this framework, the project team analyzed various features of the financings and their overall impact on Parmalat's indebtedness. In addition, we supported Brattle principal Professor Stewart Myers to rebut the plaintiffs' "deepening insolvency" damages theory.

Cover-up of Trading Losses: Refco went bankrupt several months after its IPO in 2005 due to revelation of round-trip related party loans to cover up its previous trading losses. In several suits against Ernst & Young, Refco's tax preparer (our client) brought by Refco's litigation trustee, The Brattle Group reviewed Refco's tax returns and the audited financial to analyze whether Refco's tax preparer could detect any evidence of the round-trip loans. The team also analyzed whether the alleged breach of fiduciary duty (not to blow the whistle earlier) could have caused the Refco's bankruptcy.

Fraudulent Conveyance Analysis: In anticipation of a fraudulent conveyance action involving a large leveraged buyout transaction during the financial crisis, The Brattle Group was retained by lenders to the LBO to review several valuation and solvency analyses performed at the time of the transaction.

ABOUT US

The Brattle Group provides consulting and expert testimony in economics, finance, and regulation to corporations, law firms, and governments around the world. We aim for the highest level of client service and quality in our industry.

We are distinguished by our credibility and the clarity of our insights, which arise from the stature of our experts, affiliations with leading international academics and industry specialists, and thoughtful, timely, and transparent work. Our clients value our commitment to providing clear, independent results that withstand critical review.

For more information, please visit brattle.com.

MORRISON | FOERSTER

Core Principles for Financial Regulation

Oliver Ireland and Anna Pinedo, Morrison & Foerster LLP

September 2017

NY2 796092

Executive Orders

Presidential Actions in 2017

- On January 30, 2017, President Trump issued an Executive Order titled *Reducing Regulation and Controlling Regulatory Costs*
  - Notes that the policy of the executive branch is to be "prudent and financially responsible in the expenditure of funds, from both public and private sources"
  - Establishes a regulatory cap for fiscal year 2017—unless prohibited by law, whenever an executive department or agency publicly proposes for notice and comment (or otherwise promulgates a new regulation), it must identify <u>at least two</u> existing regulations to be repealed
- On February 2, 2017, the Office of Information and Regulatory Affairs issued its *Interim Guidance Implementing Section 2 of the Executive Order of January 30, 2017*
  - Explains that departments and agencies may comply with the requirements of the Executive Order "by issuing two 'deregulatory' actions for each new significant regulatory action that imposes costs"

Executive Orders

- On February 3, 2017, President Trump signed the Executive Order titled *Core Principles for Regulating the United States Financial System*. The order outlined seven principles of regulation, or "Core Principles," which the Trump administration will follow to regulate the U.S. financial system. The principles were listed as follows:
  - 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; and
- Restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework.

- On February 24, 2017, President Trump issued an Executive Order titled *Enforcing the Regulatory Reform Agenda* which:
  - Requires regulatory reform officers and regulatory reform task forces in each agency
  - Identifies regulations that:
    - Eliminate jobs, or inhibit job creation;
    - Are outdated, unnecessary, or ineffective;
    - Impose costs that exceed benefits;
    - Create a serious inconsistency or otherwise interfere with regulatory reform initiatives and policies;

Executive Orders, cont'd.

- Are inconsistent with the requirements of Section 515 of the Treasury and General Government Appropriations Act, 2001 (44 U.S.C. 3516 note), or the guidance issued pursuant to that provision, in particular those regulations that rely in whole or in part on data, information, or methods that are not publicly available or that are insufficiently transparent to meet the standard for reproducibility; or
- Derive from or implement Executive Orders or other Presidential Directives that have been subsequently rescinded or substantially modified

- Within 90 days and thereafter report on progress, including identifying regulations for repeal, replacement, or modification

Executive Orders, cont'd.

U.S. Treasury Department Report on Core Principles for Regulating the U.S. Financial System

U.S. Treasury Department Report

- As required by the President's Executive Order 13772 setting forth the core principles that should be taken into account in connection with the regulation of the U.S. financial system, the U.S. Treasury Department published a report on June 12, 2017, identifying regulations inconsistent with the seven principles articulated in the Order
- The current report addresses only the depository system and defers an evaluation of the orderly liquidation authority established by the Dodd-Frank Act
- The report is the first in a series and we await future reports that address the regulation of the capital markets, the asset management and insurance industries, and nonbank financial services companies

- The report summarizes its recommendations as directed toward:
  - Improving regulatory efficiency and effectiveness by critically evaluating mandates and regulatory fragmentation, overlap, and duplication across regulatory agencies;
  - Aligning the financial system to help support the U.S. economy;
  - Reducing regulatory burden by decreasing unnecessary complexity;
  - Tailoring the regulatory approach based on size and complexity of regulated firms and requiring greater regulatory cooperation and coordination among financial regulators; and
  - Aligning regulations to support market liquidity, investment, and lending in the U.S. economy

U.S. Treasury Department Report, cont'd.

Regulatory Structure

- The report recommends that Congress take steps to reduce fragmentation, overlap, and duplication in financial regulation by:
  - Broadening the FSOC's mandate
    - FSOC to assign a primary regulator on issues as to which multiple agencies may have jurisdictions; and
  - Reforming the Office of Financial Research ("OFR") and making OFR part of the Treasury

Tailoring Bank Capital and Liquidity Rules

- The report suggests better tailoring of capital and liquidity rules based on an institution's size and complexity and focuses principally on the enhanced prudential standards ("EPS") requirements under Dodd-Frank. Specifically, the report recommends:
  - DFAST requirements be raised to apply to institutions with total consolidated assets of $50 billion (instead of $10 billion);
  - The mid-year DFAST be eliminated and the scenarios simplified; and
  - The threshold for the application of the EPS be reevaluated and tailored based on an entity's risk profile

CCAR

- The report suggests significant changes to the CCAR, including:
  - Increasing the threshold for the institutions that are subject to CCAR
  - Modifying the Federal Reserve's assessment approach
  - Changing CCAR to a two-year cycle
  - Requiring that the banking agencies provide greater transparency into the models and scenarios used and subjecting the framework to public notice and comment
  - Reassessing the CCAR assumptions

Liquidity Coverage Ratio

- The report suggests that the scope of the LCR be narrowed and made applicable to G-SIBs, with a less stringent standard be applied to internationally active BHCs that are not G-SIBs
- The report suggests:
  - That high-grade municipal bonds should be included as Level 2B HQLA;
  - That the banking agencies consider the effect of the current HQLA standards on the market for securitizations; and
  - A review of the net cash outflows calculations incorporated in the LCR

Countercyclical Capital Buffer

- On September 8, 2016, the Federal Reserve Board adopted a final policy statement detailing the framework the Board will follow in setting the Countercyclical Capital Buffer ("CCyB") applicable to Advanced Approaches Institutions
  - CCyB is weighted based on a banking organization's particular composition of private-sector credit exposures across national jurisdictions
  - CCyB is intended to function as an extension of the Capital Conservation Buffer
- The report suggests that CCyB be eliminated and that any countercyclical capital requirements be implemented through the operation of the CCAR/DFAST process

Supplementary Leverage Ratio (SLR)

- Finalized in September 2014, reporting began January 2015, with compliance required by January 2018
- The report is highly critical of the SLR noting its impact on market liquidity and on critical banking functions, while noting that the SLR could indirectly encourage risk taking
- As with other Basel measures (i.e., LCR, G-SIB surcharge, etc.) the report suggests that the United States reform from "gold plating" and not impose standards that are more rigorous than those required by Basel

Other Basel-Related Recommendations

- The report recommends:
  - The banking agencies modify the Method 2 calculation in the G-SIB surcharge
  - The U.S. banking agencies delay implementation of the Fundamental Review of the Trading Book rules in order to allow for a more complete assessment
  - Establishment of global risk-based capital floors
  - Recalculation of the minimum long-term debt ratios that are included in the Federal Reserve's final TLAC rule so that these are not more punitive than the Financial Stability Board's final TLAC requirements

Improving the Regulatory Engagement Mode

- The report suggests re-evaluating the requirements imposed on the boards of directors of depository institutions
- According to the report, banking agencies should be subject to a uniform and more rigorous cost-benefit analysis requirement in order to improve the rulemaking process
- The report recommends an interagency assessment of the approach to identifying matters requiring attention, matters requiring immediate attention, and consent orders in order to achieve more consistency and transparency

Living Will Requirements

- The report suggests raising the threshold for living will requirements from $50 billion in total consolidated assets to match the revised threshold for EPS, making the process subject to a two-year cycle, and improving the guidance provided by regulators in response to living will submissions
- The FDIC should be eliminated from the living will process, according to the report, and the Federal Reserve should be required to review and provide feedback within six months

Foreign Banking Organizations

- The report recommends reassessing the regulations applicable to foreign banks so that these institutions are not unduly contained
- The report reviews various requirements applicable to foreign banking organizations, including the EPS requirements, the living will requirements, the intermediate holding company (IHC) requirement, and the capital and other requirements applicable to IHCs. The report suggests that:
  - EPS and living will requirements be based on a foreign bank's U.S. risk profile and not on the entity's global consolidated assets;
  - Threshold for IHCs to comply with U.S. CCAR requirements be raised consistent with the higher threshold recommended for U.S. BHCs;
  - The living will and other requirements applicable to IHCs be reevaluated and where home country requirements are sufficiently comparable, foreign banks should be allowed to meet U.S. requirements by meeting their home country standards; and
  - Other requirements applicable to IHCs, such as the internal TLAC requirement, be recalibrated

Volcker Rule

- The report recommends exempting smaller institutions (banks with $10 billion or less in total consolidated assets) from all aspects of the Volcker Rule
  - Banks with over $10 billion in total consolidated assets that have limited trading assets and liabilities would be exempt from the proprietary trading restrictions of the rule (but subject to the covered funds provisions of the rule)
- The report notes the need for better coordination among the agencies charged with oversight for Volcker Rule compliance
- The report would simplify the definition of "proprietary trading" by eliminating the "purpose test" and eliminating the rebuttable presumption of proprietary trading in respect of financial instruments held for fewer than 60 days

- The report notes the negative effect of the rule on market-making activity and suggests that regulators give banks additional flexibility to adjust their determinations of the reasonable amount of inventory
- The report raises other possible approaches to modifying the reasonably expected near-term demand (RENTD) requirement
- The compliance and recordkeeping burdens associated with hedging activities
- The report makes a number of suggestions that are intended to simplify the covered fund restrictions, as well as reduce the burdens associated with the compliance program requirements
  - All of the suggestions regarding the rule are qualified by a final recommendation that consideration be given to implementing an "off-ramp" approach by which banks that are sufficiently well-capitalized, such that they can address risks posed by proprietary trading, would cease to be subject to the rule's prohibitions

Volcker Rule, cont'd.

Leveraged Lending

- The report cites a number of shortcomings in the banking agencies' leveraged lending guidance and notes that the guidance leaves ambiguity regarding the definition of "leveraged lending"
- The report explains that the guidance lacked clear penalties for noncompliance
- The report recommends that the guidance be re-issued for public comment
- Following the comment period, the guidance should be refined with a view toward avoiding ambiguity and achieving consistency in supervision, examination, and enforcement
- Banks should also be encouraged, according to the report, to incorporate a clear and robust set of metrics when underwriting a leveraged loan rather than relying solely on a 6x leverage ratio discussed in the existing guidance

Small Business Lending

- The report notes a number of impediments to small business lending and, in order to promote small business lending, the report recommends:
  - Changes to the regulatory framework for community banks and credit unions, institutions which are critical to small business lending;
  - Changes to the leveraged lending guidance, which should result in improved access to capital for small and medium-sized businesses;
  - Changes to banking agency guidance relating to commercial real estate lending;
  - Addressing the calibration of the SLR for working capital loans and unfunded lines of credit to small businesses; and
  - Repealing Section 1071 of the Dodd-Frank Act, which requires that the CFPB establish regulations and issue guidance for small business loan collection

OCC Request for Comment on Volcker Rule

OCC Request for Comment

- There have been various Volcker Rule related developments, including a release that provides temporary relief for foreign banking organizations with respect to investments in certain foreign private funds, as well as another that provided guidance on applications for extensions for the seeding period when a banking entity organizes a covered fund
- Then, in August 2017, the OCC released a notice and request for comment (Request for Comment) on how to modify the implementing regulations, as well as the application and administration of the Volcker Rule
- The Request for Comment focuses on:
  - **Scope of Banking Entities Subject to the Rule:** The release suggests that certain entities may not be engaged in activities that pose the risks that the rule was intended to mitigate, including small and community banks, as well as banks with limited trading activities

- **Foreign Funds**: The OCC requests comment on tailoring of the rule's scope to foreign funds that have a U.S. nexus
- **Banking Entity Definition**: The release seeks comment on the definition of "banking entity" and the exclusions from that definition
- **Proprietary Trading Ban**: The request solicits comment regarding ways in which the exclusions and exemptions relating to proprietary trading can be simplified in order to relieve the regulatory burden. In that regard, the release notes that the "purpose test" may impose too significant a compliance burden on banking entities. The release also requests comment on the 60-day rebuttable presumption of proprietary trading
- **Covered Fund Definition**: The release notes that the definition of "covered fund" may be too technical in its references to the 1940 Act as well as overly broad. The release requests comment on an exclusion for venture capital funds

OCC Request for Comment, cont'd.

- **Super 23A**: The OCC requests comment on whether there ought to be additional exceptions to the restrictions on affiliated transactions and specifically references certain securitization transactions
- **Compliance Program and Metrics**: The request seeks feedback on the compliance burden associated with the various reporting requirements

OCC Request for Comment, cont'd.

Fed Proposals to Ease Burden on Bank Boards of Directors

Easing the Burden on Bank Boards

- In August 2017, the Federal Reserve issued two proposals, one relating to governance and one relating to a new financial institution rating system
- The governance proposal outlines an approach that is intended to provide clearer guidance regarding supervisory expectations and would:
  - Outline attributes for an effective board
  - Redirect responsibilities to management
  - Limit the extent to which MRIAs and MRAs are addressed to boards

Board Effectiveness

- Proposed guidance applies to domestic BHCs and SLHCs as well as nonbank SIFIs with total consolidated assets in excess of $50 billion
- Guidance does not apply to IHCs of FBOs; however, the Fed indicates that it will provide guidance for IHC boards in the future
- Boards are effective when focused on establishing firmwide strategy and setting risk levels; the proposal identifies five attributes for an effective board:
  - Set clear, aligned and consistent direction regarding strategy and risk tolerance
  - Actively manage information flow and board discussions
  - Hold senior management accountable
  - Support independence and stature of independent risk management and internal audit
  - Maintain a capable board and an appropriate governance structure

Streamlining Board Guidance and Addressing MRIAs and MRAs

- The proposal would revise existing supervisory expectations relating to bank boards, including 27 supervision and regulation letters
- The general objective is to return to having supervisory guidance that is less granular and removing matters that are more appropriate for bank management teams
- Most MRIAs and MRAs will be directed to management rather than to boards, with MRIAs and MRAs addressed to boards only to the extent that there are significant governance failings that are identified by banking agencies

Client Alert

August 3, 2017

OCC Seeks Public Comment on the Volcker Rule

Section 13 of the Bank Holding Company Act (the "Volcker Rule") and its implementing regulations (the "Implementing Regulations") generally prohibit banking entities from engaging in proprietary trading and from investing in, sponsoring, or having certain relationships with covered funds.

On August 2, 2017, the Office of the Comptroller of the Currency ("OCC") submitted to the *Federal Register* a notice requesting public comment on how the Implementing Regulations should be revised to better accomplish the purposes of the Volcker Rule while decreasing the compliance burden on banking entities and fostering economic growth (the "Notice"). The Notice also requests input concerning "how the existing rule could be implemented more effectively without revising the regulation."[1]

The OCC is seeking public input on all aspects of the Implementing Regulations but specifically requested comment on four topics:

(i) the scope of entities subject to the Implementing Regulations;

(ii) the proprietary trading prohibition;

(iii) the covered funds prohibition; and

(iv) the compliance program and metric reporting requirements.

In order to support revisions to the Implementing Regulations, the Notice emphasizes that "it is especially important for those commenting to provide evidence demonstrating the nature and scope of the problems they identify and the likely efficacy of any solutions they propose."[2] Although the OCC appears to be acting independently of the other four regulators that have adopted the Implementing Regulations,[3] the initiative may serve to kick-start a regulatory review process that could lead to a reduction in some of the burdens of the Volcker Rule, albeit within the constraints of the statutory language. The Notice, and other recent activity regarding the Volcker Rule by banking regulators, is also largely consistent with recommendations set forth in the report from the U.S. Department of the Treasury outlining the administration's proposal for reforming regulations related to banks and credit unions.[4]

Comments will be due 45 days from the date of publication in the *Federal Register*. A more detailed discussion of the topics identified in the Notice follows.

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[1] The Notice clarifies that the OCC is not seeking comment on changes to the underlying Volcker statute. A copy of the Notice is available at: https://www.occ.gov/news-issuances/news-releases/2017/nr-occ-2017-89a.pdf. The OCC's press release is available at: https://www.occ.gov/news-issuances/news-releases/2017/nr-occ-2017-89.html.

[2] In the Notice, the OCC also clarifies that it "recognizes that revisions to the current rule must be undertaken jointly by the OCC, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation and in consultation and coordination with the Securities and Exchange Commission and the Commodity Futures Trading Commission."

[3] The other four regulators include the Board of Governors of the Federal Reserve System, the U.S. Securities and Exchange Commission, the Commodity Futures Trading Commission, and the Federal Deposit Insurance Corporation.

[4] The U.S. Department of the Treasury report is available at: https://www.treasury.gov/press-center/press-releases/Documents/A Financial System.pdf.

SCOPE OF ENTITIES SUBJECT TO THE VOLCKER RULE

The Volcker Rule's prohibition on proprietary trading applies to any banking entity. The term "banking entity" is defined broadly to include any insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for the purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any of the foregoing entities.[5]

As a result, according to the Notice, the Implementing Regulations apply to "many entities that may not pose systemic risk concerns, such as small, community banks engaged primarily in traditional banking activities and other banks that do not engage in the type of activities, or in activities that present the type of risk, that the Volcker Rule was designed to restrict." Although the Implementing Regulations contain tailored compliance program requirements designed to relieve regulatory burdens on smaller banking entities, the Notice remarks that "even determining whether an entity is eligible for the simplified program can pose a significant burden for small banks." The Notice also observes that the banking entity definition extends to funds that are deemed to be controlled by foreign banking organizations.[6]

The Notice solicits input on, among other things: (i) evidence that the scope of the Implementing Regulations is too broad; (ii) suggestions on revisions to the Implementing Regulations to narrow their application and reduce any unnecessary compliance burden; and (iii) ways to carve out foreign excluded funds "controlled" by banking entities.[7]

PROPRIETARY TRADING PROHIBITION

The Implementing Regulations define "proprietary trading" as "engaging as principal for the trading account of the banking entity in any purchase or sale of one or more financial instruments."[8] The Notice identifies two issues with the Implementing Regulations' definition of proprietary trading.

First, the term "trading account" is defined to include (among other things) an account that is used by a banking entity to purchase or sell financial instruments principally for certain enumerated purposes.[9] The Notice states that "[b]anking entities and commentators have asserted that [the purpose test] imposes a significant compliance burden because it requires determining the intent associated with each trade."

Second, the Implementing Regulations contain a presumption that the purchase or sale of a financial instrument is for a trading account if the banking entity "holds the financial instrument for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase."[10] The Notice states that banking entities have asserted that this presumption may capture transactions that are not the intended target of the Volcker Rule.

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[5] 12 C.F.R. § 44.2(c)(1). Subsection 44.2(c)(2) contains certain exclusions from this definition. All citations herein are to regulations promulgated by the OCC.

[6] On July 21, 2017, the OCC, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation jointly released their Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act. The statement establishes a one-year moratorium on enforcement of the Volcker Rule against certain "qualifying foreign excluded funds." For additional information, please see our July 24, 2017 Client Alert, "Federal Banking Agencies Announce No-action Position on Certain Foreign Excluded Funds Under the Volcker Rule," available at: https://media2.mofo.com/documents/170724-federal-agencies-foreign-funds-volcker.pdf.

[7] *See id.* (discussing the recent one-year moratorium on enforcement against certain "qualifying foreign excluded funds").

[8] 12 C.F.R. § 44.3(a).

[9] These purposes are: (A) short-term resale; (B) benefitting from actual or expected short-term price movements; (C) realizing short-term arbitrage profits; or (D) hedging one or more positions resulting from the purchases or sales of financial instruments described in (A) through (C). 12 C.F.R. § 44.3(b)(1)(i).

[10] 12 C.F.R. § 44.3(b)(2).

The Notice solicits input on, among other things: (i) whether the rebuttable presumption should be revised or eliminated or replaced with a reverse presumption; (ii) whether additional activities should be permitted under the proprietary trading provisions; and (iii) ways to simplify and streamline the existing exclusions and exemptions.

COVERED FUNDS PROHIBITION

The Volcker Rule generally prohibits banking entities from holding or acquiring an ownership interest in, or sponsoring, any private equity fund or hedge fund. The Volcker Rule defines "hedge fund" and "private equity fund" as an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (the "Investment Company Act") but for section 3(c)(1) or 3(c)(7) thereof, or such similar funds as the agencies may, by rule, determine.[11] The agencies defined the term "covered fund" in the Implementing Regulations by referencing sections 3(c)(1) and 3(c)(7) of the Investment Company Act and also by including certain commodity pools and foreign funds.[12]

The Implementing Regulations' so-called "Super 23A" provision also implements the Volcker Rule's limitations on relationships with private equity funds and hedge funds.[13]

The Notice solicits input on, among other things: (i) whether the covered fund definition is too broad; (ii) ways to narrow the covered fund definition; (iii) information regarding the effectiveness of the Super 23A provision; and (iv) whether there are any categories of transactions and relationships that should be permitted under the Super 23A provision.

COMPLIANCE PROGRAM AND METRIC REPORTING REQUIREMENTS

The Implementing Regulations establish compliance program requirements based on the size, complexity, and type of activity conducted by a banking entity. According to the Notice, "banking entities have reported that the compliance program requirements in the [Implementing Regulations] present a compliance burden, especially for small institutions that are not engaged in significant levels of proprietary trading and covered fund activities."

The Notice solicits input on, among other things: (i) evidence that the compliance program and metrics reporting requirements present a disproportionate or undue burden on banking entities; (ii) ways to revise the Implementing Regulations to reduce the burden associated with the compliance program and reporting requirements; and (iii) whether there are categories of entities for which compliance program requirements should be reduced or eliminated.

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[11] 12 U.S.C. § 1851(h)(2).

[12] 12 C.F.R. § 44.10(b).

[13] 12 C.F.R. § 44.14.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations. Prior results do not guarantee a similar outcome.

A Timeline of Recent

PRESIDENTIAL ACTIONS

on Regulation Reduction

Jan. 20, 2017
Donald Trump assumes office as 45th President of the United States.

Jan. 30, 2017
President signs Presidential Executive Order on Reducing Regulation and Controlling Regulatory Costs. (Also known as the "two-fer" order)
https://goo.gl/hd4cHm

Feb. 1, 2017
President issues Statement of Administration Policy including H.J. Res. 41 – Disapproving the Securities And Exchange Commission's Rule On Disclosure Of Payments by Resource Extraction Issuers.
https://goo.gl/c9Q2LM

Feb. 3, 2017
President signs Presidential Executive Order on Core Principles for Regulating the United States Financial System.
https://goo.gl/p9AcGc
and
President issues Presidential Memorandum on Fiduciary Duty Rule.
https://goo.gl/r9axRc

Feb. 14, 2017
President signs H.J.Res.41 "Providing for congressional disapproval under chapter 8 of title 5, United States Code, of a rule submitted by the Securities and Exchange Commission relating to 'Disclosure of Payments by Resource Extraction Issuers'" into Public Law No: 115-4.
https://goo.gl/NbzARg

Feb. 24, 2017
President signs Presidential Executive Order on Enforcing the Regulatory Reform Agenda. (Orders Regulatory Reform Officers and Regulatory Reform Task Forces to be created).
https://goo.gl/tEBLyl

Mar. 2, 2017
Department of Labor proposes a 60-day delay in the applicability date of its Fiduciary Rule and related exemptions. The action opened a 45-day period seeking public comment on the merits of the Fiduciary Rule.
https://goo.gl/FmqoQj

Apr. 21, 2017
President issues a Presidential Memorandum to the Secretary of the Treasury directing a review of the Orderly Liquidation Authority ("OLA").
https://goo.gl/QvNc1g

Apr. 21, 2017
President issues a Presidential Memorandum to the Secretary of the Treasury directing a thorough review of the Financial Stability Oversight Council ("FSOC") determination and designation processes.
https://goo.gl/5MEVTd
and
President signs Presidential Executive Order on Identifying and Reducing Tax Regulatory Burdens.
https://goo.gl/5vSWl6

Jun. 12, 2017
U.S. Treasury Department releases report on Core Principles for Regulating the United States Financial System, as required by Executive Order 13772.
https://goo.gl/gHstU5

Jun. 29, 2017
Department of Labor issued a Request for Information in connection with its examination of the Final Fiduciary Rule.
https://goo.gl/8t1L8e

Jul. 13,.2017
U.S. Treasury Department hosts Roundtable on FSOC Designations, as a part of a series of outreach meetings with stakeholders to seek views on the Presidential Memorandum on the FSOC determination and designation processes.
https://goo.gl/4kQZJ6

Source: http://www.whitehouse.gov/

Reform or recalibration?

In the absence of legislative proposals from the Trump Administration, the US Congress looks to roll back Dodd-Frank. But while any dramatic changes are unlikely, the sector will have to implement a number of changes

1 MINUTE READ

The newly-released update of the Financial CHOICE Act has sparked partisan debate about both the value of the act and the underlying causes behind the financial crisis.

The CHOICE Act would repeal parts of the Dodd-Frank Act, including the Volcker Rule and title II, the Durbin Amendment relating to price controls on debit card interchange fees, as well as the Department of Labor's fiduciary rule.

It is likely not the only path for financial services reform as other bills have been introduced in the Senate in prior sessions of Congress. But it is so far the most wide-ranging and comprehensive one.

In the last session of the US Congress in mid-2016, representative Jeb Hensarling first introduced the Financial CHOICE (Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs) Act. This represented an amalgamation of new proposals as well as numerous individual measures that had been introduced in Congress, as a comprehensive deregulatory bill. The Financial CHOICE Act failed to advance much beyond the Financial Services Committee of the House of Representatives in 2016. Given the new presidential administration's deregulatory agenda, it has been anticipated that new legislation would be introduced to carry forward campaign commitments to repeal the Dodd-Frank Act. However, thus far, from the administration itself there have been only various presidential orders, such as the executive order relating to the core principles for regulating the United States financial system (order 13772), which addresses the principles pursuant to which effective financial services regulation should be evaluated for potential amendment or repeal. To fill the breach, representative Hensarling introduced a new version of the Financial CHOICE Act, referred to as CHOICE 2.0, in the House of Representatives – this was recently adopted by the House Financial Services Committee. While it is unlikely, given the many disparate measures that comprise the draft of the proposed legislation, that CHOICE 2.0 will be enacted in its current form, it is worth reviewing the principal provisions and the measures that might find broad support.

Overview of the CHOICE Act

Like the predecessor bill, CHOICE 2.0 covers a lot of ground by addressing elements of the Dodd-Frank Act, adopting amendments intended to promote capital formation, and limiting the independence of various government agencies, by, among other things, requiring significant changes to the cost-benefit assessments required prior to adoption of new regulations.

The Dodd-Frank Act related provisions

The CHOICE Act would repeal the Volcker Rule, the Durbin Amendment relating to price controls on debit card interchange fees, as

well as the Department of Labor's (DoL) fiduciary rule. The DoL would be prohibited from adopting a fiduciary rule unless the Securities and Exchange Commission (SEC) were to adopt a fiduciary standard for broker-dealers, and, in such case, the rules adopted by the two agencies would have to be substantially similar.

The CHOICE Act also would repeal title II of the Dodd-Frank Act, which provides for the orderly resolution of systemically important financial institutions and replace it with amendments to the Bankruptcy Code designed to address complex financial institutions. In addition, the Federal Deposit Insurance Corporation (FDIC) would be relieved of responsibility for any resolution planning review. Immediately after the financial crisis, the US, together with the other members of the G20 agreed to undertake certain measures to prevent future financial crises, of which orderly resolution of systemically important entities was a cornerstone. The CHOICE Act would repeal the authority of the Financial Stability Oversight Council (FSOC) which is tasked with designating institutions as systemically important. The legislation would repeal title VIII of the Dodd-Frank Act pursuant to which the FSOC designates financial market utilities including payment and clearing systems, as systemically important.

The CHOICE Act addresses the concerns expressed by many commentators that the Dodd-Frank Act is over-broad and takes a one-size fits all approach to bank regulation by proposing regulatory relief for qualifying banking organisations that opt to avail themselves of off ramp provisions. To the extent that a bank maintains an average total leverage ratio of 10% or more, including, for larger institutions, off-balance sheet exposures, the qualifying banking organisation would be relieved of compliance with Basel III regulatory capital requirements, liquidity requirements, living will requirements, the enhanced prudential standards, stress tests, and several limitations on merger activities. Banks not eligible for the off ramp would nevertheless benefit from more relaxed stress test requirements.

The CHOICE Act would rename the Consumer Financial Protection Bureau (CFPB) as the Consumer Law Enforcement Agency – an executive agency outside of the Federal Reserve System led by a single director appointed by, and subject to at-will removal by, the US president. The agency's authority would be circumscribed as it would no longer be able to bring actions relating to unfair, deceptive, or abusive acts or practices; would have no supervisory or examination authority; would eliminate its enforcement authority over insured depositories; and would have no authority with respect to payday, small dollar and similar loans. In connection with any proposed new regulations, the agency would have to conduct a rigorous cost-benefit analysis that takes into account the impact on consumer price, choice and access of any measure.

Executive compensation-related provisions of the Dodd-Frank Act, such as the pay ratio, hedging, incentive compensation and clawback provisions, as well as the specialised disclosure requirements, would be repealed. Various Dodd-Frank Act provisions relating to credit rating agencies would be modified in an effort to remove barriers to entry.

Capital formation measures

The CHOICE Act incorporates provisions from various standalone bills that are designed to promote capital formation by relaxing the burdens associated with becoming a US public company, and that would extend Jumpstart Our Business Startups (Jobs) Act-related accommodations to more companies. For example, the CHOICE Act would:

- make changes to certain provisions of the Investment Company Act in order to repeal certain registration and reporting requirements for private fund advisers;
- relax the threshold for additional disclosure requirements for stock-based compensation grants under rule 701 of the Securities Act, for private companies;
- modernise section 12(g) registration requirements under the Securities Exchange Act for smaller companies by eliminating the requirement to verify annually accredited investor status and increasing the revenue and shareholder thresholds;
- reform the initial public offering (IPO) process by permitting all issuers, not just emerging growth companies (a category established by the Jobs Act) to benefit from the ability to submit their IPO registration statements to the SEC on a confidential basis and to test the waters to assess investor interest.
- enable a national securities exchange to elect to be treated as a venture exchange to encourage smaller company IPOs;
- reduce the burdens for smaller public companies by expanding eligibility for use of the short-form, or shelf, registration to more companies, providing relief to more companies from the requirements under section 404(b) of the Sarbanes-Oxley Act for auditor attestation of an issuer's internal control over financial reporting, and relieving certain issuers from the Extensible Business Reporting Language requirements for financial statements and other periodic reporting;
- amend various provisions of the securities laws relating to exempt offerings – for example, by broadening the statutory exemption under section 4(a)(7) of the Securities Act for the resale of restricted securities, modifying the definition of accredited investor, revising the prohibitions against general solicitation, establishing a safe harbour under the Securities Act for certain micro offerings, and amending the regulations applicable to crowdfunded offerings; and
- establish a streamlined process pursuant to which the SEC would evaluate new products, like exchange-traded funds.

Limits on agency authority

The CHOICE Act is expected to limit the authority of all federal financial regulators, incorporating the provisions of various predecessor bills, including the Regulations from the Executive in Need of Scrutiny Act (Reins Act), by changing the appropriations process, establishing a new standard relating to cost-benefit analysis and implementing structural reforms. These measures would have their most significant effects on the authority of the Federal Reserve and the SEC. The Federal Reserve's authority to supervise and issue regulations relating to nonbank financial companies would be repealed. The Federal Reserve's authority would be repealed with respect to certain measures applicable to the enhanced prudential standards, measures affecting qualifying banking organisations, measures limiting further the Federal Reserve's emergency lending powers, and measures that could have the effect of limiting certain aspects of the Federal Reserve's discretion with respect to monetary policy. The act would subject the new Consumer Law Enforcement Agency, the FDIC, the Office of the Comptroller of the Currency (OCC) and the National Credit Union Administration (NCUA) to the congressional appropriations process.

The agency rulemaking process for the Federal Reserve, OCC, FDIC, SEC, Commodity Futures Trading Commission, NCUA and the Federal Housing Finance

Agency would be revised to require that all preliminary and final factual determinations be based on certain evidence. A federal agency would be required to consider, among other factors: the legal authority under which a rule may be proposed, the specific nature and significance of the problem the rule addresses, and any reasonable alternatives. Rulemaking notice requirements would be revised to require agencies to, among other things:

- publish in the Federal Register advance notice of proposed rulemaking involving a major or high-impact rule;
- hold a hearing before the adoption of any high-impact rule; and
- provide interested persons with an opportunity to participate in the rule-making process.

The CHOICE Act also would limit the SEC's enforcement authority by:

- repealing the SEC's authority to bar individuals from serving as officers and directors by administrative action;
- requiring that the SEC determine before imposing civil penalties on an issuer whether the issuer directly benefited from the alleged securities violation and whether the penalty would harm the issuer's shareholders;
- establishing a committee, the Wells Committee 2.0, to evaluate the SEC's enforcement policies and practices;
- requiring enforcement coordination among all financial regulators to minimise duplication;
- prohibiting rulemaking by enforcement; and
- repealing the so-called Chevron doctrine of judicial deference to the interpretations of the SEC and other federal agencies.

Possible areas of consensus and compromise

The CHOICE Act likely is not the only path for financial services reform. There have been other bills introduced in the Senate in prior sessions of Congress that are designed to roll back many of the more controversial provisions of the Dodd-Frank Act. Also, several of the president's executive oders require that the federal agencies identify existing regulations, which, based on the core principles for financial services regulation, ought to be re-evaluated, amended, or repealed. Trade groups have already begun to offer their assessments and recommendations regarding changes to existing regulations that ought to be made in order for such regulations to meet the standards articulated in the president's executive orders. Regulatory reform officers within the federal agencies must deliver their reports this summer, and these might form the basis for the administration's plan to dismantle the Dodd-Frank Act. The hearings and debate relating to the CHOICE Act were predictably divided along party lines but proved informative because they identified areas where consensus may be within reach. This is especially true if sections of the CHOICE Act were to be presented as standalone bills for consideration. We would include the following within this category:

Capital formation measures

Many, if not most, of the provisions of the CHOICE Act relating to capital formation, including provisions extending the benefit of the Jobs Act to more companies, and easing burdens for smaller companies are likely to have considerable support. Particularly in light of the intense focus on the need to reinvigorate the US IPO market, the measures that are intended to reduce the burdens on US SEC-reporting companies are also likely to receive support, provided that investor protections are not seen as weakened. With a new SEC chair now in place, it is possible that the SEC may take action on other measures, like its disclosure effectiveness initiative, that are intended to streamline and modernise corporate disclosures.

Executive compensation and related Dodd-Frank Act provisions

Several of the specialised disclosure provisions slated for repeal already have faced court challenges and are being revisited by the SEC. Thus, it is likely that many will not survive. Also, various measures identified for repeal in the CHOICE Act were the subject of proposed, not yet final, rules, like the measures related to incentive compensation. In light of the current political climate, it is likely that many measures still in the proposed category will never be finalised.

Stress tests

Even before the new administration was in place, the banking agencies had already begun to review and revisit elements of the stress test requirements. There is consensus that it may be appropriate to continue to make changes to these requirements.

Regulatory relief for smaller banks

There is bipartisan support for measures that would relieve regulatory burdens on community and smaller regional banks, although the off ramp provisions are unlikely to be the path forward toward accomplishing this.

Systemic designation

There is some consensus regarding the need to revisit the process for designating financial institutions, especially nonbank financial institutions, as systemically significant.

Volcker rule

Following publication of various studies, including a research study undertaken by the Federal Reserve, there is some consensus regarding the need to assess the effects of the rule on liquidity and market making. A full repeal of the rule is unlikely.

CFPB reforms

Any Dodd-Frank rollback will involve some restructuring of the CFPB, and limitations on the scope of the Bureau's supervisory and oversight authority.

Finally, both democratic and republican administrations for many years now have sought to bring more rigour to the cost-benefit analysis required in connection with the assessment of proposed, and the re-evaluation of existing, regulations. While it is unlikely that we will see the dramatic changes in agency structure, appropriations, and enforcement powers outlined in the CHOICE Act, it is likely that any regulatory reform measure will recalibrate the cost-benefit and economic analysis required in connection with new regulations.

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Client Alert

June 13, 2017

U.S. Treasury Department Report on Core Principles for Regulating the United States Financial System

As required by the President's Executive Order 13772 setting forth the core principles that should be taken into account in connection with the regulation of the U.S. financial system, the U.S. Treasury Department published a report identifying regulations inconsistent with the seven principles articulated in the order.[1] The report is the first of series of reports. The current report addresses only the depository system and defers an evaluation of the orderly liquidation authority established by the Dodd-Frank Act. We await future reports that address the regulation of the capital markets, the asset management and insurance industries, and non-bank financial services companies. The report notes that stimulating economic growth depends, in the administration's view, on relieving regulatory burdens on financial institutions and establishing a more efficient system of financial regulation. The report not only identifies regulations inconsistent with the core principles but also recommends changes in varying degrees of specificity and identifies whether the recommendations contemplate regulatory changes or Congressional actions. Thus the report provides both recommendations and a general road map for implementing changes. The report summarizes its recommendations as directed toward:

- Improving regulatory efficiency and effectiveness by critically evaluating mandates and regulatory fragmentation, overlap and duplication across regulatory agencies;
- Aligning the financial system to help support the U.S. economy;
- Reducing regulatory burden by decreasing unnecessary complexity;
- Tailoring the regulatory approach based on size and complexity of regulated firms and requiring greater regulatory cooperation and coordination among financial regulators; and
- Aligning regulations to support market liquidity, investment, and lending in the U.S. economy.

Below we summarize briefly several of the principal areas of recommendations included in the report. This summary does not address the recommendations relating to the regulation of community banks, the mortgage markets, or matters relating to the Consumer Financial Protection Bureau, which we will address in a separate alert.

Regulatory Structure

The report recommends that Congress take steps to reduce fragmentation, overlap and duplication in financial regulation. In order to do so, the report recommends that:

- The Financial Stability Oversight Council's (FSOC) mandate be broadened so that FSOC can assign a primary regulator on issues as to which multiple agencies may have jurisdiction; and

[1] See our chart summarizing the Presidential Executive Orders here.

- The Office of Financial Research (OFR) be reformed so that its effectiveness is improved and would make the OFR part of Treasury, with a director to be appointed by the Treasury Secretary, without a fixed term, subject to removal at will, and a budget controlled by the Treasury Department.

Tailoring of Bank Capital and Liquidity Rules

The report concludes that existing regulations do not go far enough in tailoring capital and liquidity rules. In order to remedy this, the report suggests better tailoring of rules based on an institution's size and complexity. The report focuses principally on the enhanced prudential standards (EPS) requirements that arose under the Dodd-Frank Act, including the various current stress-testing requirements. Specifically, the report recommends:

- Company-run Dodd-Frank Act Stress Test (DFAST) requirements be raised to apply to institutions that have total consolidated assets of $50 billion (instead of $10 billion), with some discretion allowed to banking agencies to calibrate the threshold upward from time to time based on an institution's activities;
- The mid-year DFAST be eliminated and the scenarios simplified;
- The threshold for the application of the EPS be re-evaluated and tailored based on an entity's risk profile; and
- The scope of the liquidity coverage ratio (LCR) be narrowed and made applicable to globally systemically important banks (G-SIBs) with a less stringent standard applied to internationally active bank holding companies (BHCs) that are not G-SIBs.

The report also suggests the possibility of an alternative regulatory "off ramp" approach like that reflected in the Financial CHOICE Act.

The report recommends increasing the transparency of regulatory requirements. For example, the report suggests that stress-testing and capital planning review frameworks be subject to public notice and comment. The Comprehensive Capital Analysis and Review (CCAR) process should be simplified to allow bank management greater control of capital distribution planning. The countercyclical capital buffer would be eliminated and any countercyclical capital requirements would be implemented through the DFAST and CCAR processes.

The report also notes the interaction of the leverage ratio, the enhanced supplementary leverage ratio (eSLR) and other capital rules as limiting the ability of banks to engage in certain critical banking functions. Consequently, the report suggests changes to the calculation of the SLR, expanding the treatment of certain instruments as high quality liquid assets (HQLA) for purposes of the LCR, and modifying LCR cashflow assumptions incorporated into the calculations of the LCR.

The report suggests reevaluating capital and liquidity requirements that exceed those mandated by Basel III or other standard-setting bodies and cites three such areas where recalibration is needed: the U.S. G-SIB risk-based surcharge and its focus on short-term wholesale funding reliance, the mandatory minimum debt ratio in the total loss absorbing capacity (TLAC) and eligible long-term debt rules, and the calibration of the eSLR.

Improving the Regulatory Engagement Model

The report suggests re-evaluating the requirements imposed on the boards of directors of depository institutions. According to the report, banking agencies should be subject to a uniform and more rigorous cost-benefit analysis requirement in order to improve the rulemaking process. The cost-benefit analysis would be included in proposed rules and made available for public comment. The report recommends an interagency assessment of the approach to identifying matters requiring attention, matters requiring immediate attention, and consent orders in order to achieve more consistency and transparency.

Living Will Requirements

The report suggests raising the threshold for living will requirements from $50 billion in total consolidated assets to match the revised threshold for EPS, making the process subject to a two-year cycle, and improving the guidance provided by regulators in response to living will submissions. The FDIC should be eliminated from the living will process, according to the report, and the Federal Reserve should be required to review and provide feedback within six months.

Foreign Banking Organizations

The report recommends reassessing the regulations applicable to foreign banks so that these institutions are not unduly contained. The report reviews various requirements applicable to foreign banking organizations, including the EPS requirements, the living will requirements, the intermediate holding company (IHC) requirement, and the capital and other requirements applicable to IHCs. The report suggests that:

- The EPS and living will requirements be based on a foreign bank's U.S. risk profile and not on the entity's global consolidated assets;
- The threshold for IHCs to comply with U.S. CCAR requirements be raised consistent with the higher threshold recommended for U.S. bank holding companies;
- The living will and other requirements applicable to IHCs be reevaluated and where home country requirements are sufficiently comparable, foreign banks should be allowed to meet U.S. requirements by meeting their home country standards; and
- Other requirements applicable to IHCs, such as the internal TLAC requirement, be recalibrated.

Volcker Rule

The report recommends exempting smaller institutions from the Volcker Rule (those banks with $10 billion or less in total consolidated assets) from all aspects of the rule, while banks with over $10 billion in total consolidated assets that have limited trading assets and liabilities would be exempt from the proprietary trading restrictions of the rule (but subject to the covered funds provisions of the rule). The report notes the need for better coordination among the agencies charged with oversight for Volcker Rule compliance. In addition to these changes, the report would simplify the definition of "proprietary trading" by eliminating the "purpose test" and eliminating the rebuttable presumption of proprietary trading in respect of financial instruments held for fewer than 60 days. The report notes the negative effect of the rule on market-making activity and suggests that regulators give banks additional flexibility to adjust their determinations of the reasonable amount of inventory. The report raises other possible approaches to modifying the reasonably expected near-term demand (RENTD) requirement. The compliance and recordkeeping burdens associated with hedging activities. The report also makes a number of suggestions that are intended to simplify the covered fund restrictions, as well as reduce the burdens associated with the compliance program requirements. All of the suggestions regarding the rule are qualified by a final recommendation that consideration be given to implementing an "off-ramp" approach by which banks that are sufficiently well-capitalized, such that they can address risks posed by proprietary trading, would cease to be subject to the rule's prohibitions.

Leveraged Lending

The report cites a number of shortcomings with the banking agencies' leveraged lending guidance. For example, the report notes that the guidance leaves ambiguity regarding the definition of "leveraged lending." The report also explains that the guidance lacked clear penalties for noncompliance. As a result of the ambiguity and confusion created by the guidance, the report recommends that the guidance be re-issued for public comment. Following the comment period, the guidance should be refined with a view toward avoiding ambiguity and achieving consistency in supervision, examination, and enforcement. Banks also should be encouraged, according

to the report, to incorporate a clear and robust set of metrics when underwriting a leveraged loan rather than relying solely on a 6x leverage ratio discussed in the existing guidance.

Small Business Lending

The report notes a number of impediments to small business lending and in order to promote small business lending, the report recommends:

- Changes to the regulatory framework for community banks and credit unions, which institutions are critical to small business lending;
- Changes to the leveraged lending guidance, which should result in improved access to capital for small and medium-sized businesses;
- Changes to banking agency guidance relating to commercial real estate lending;
- Addressing the calibration of the SLR for working capital loans and unfunded lines of credit to small businesses; and
- Repealing Section 1071 of the Dodd-Frank Act, which requires that the CFPB establish regulations and issue guidance for small business loan collection.

Conclusion

These recommendations and the assignments of responsibility for carrying them out are one part of a multi-pronged approach to addressing current issues of regulatory burden. The passage of the CHOICE Act by the House of Representatives last week and the start of hearings in the Senate Banking Committee provide momentum for potential legislative changes. The President's announcement of his intent to nominate Joseph Otting for Comptroller of the Currency also starts the process of administration appointments to the depository institution regulatory agencies which will play a key role in implementing recommended regulatory changes as well as any statutory changes. At the same time many details are yet to be resolved. There are differences between the Treasury report and the CHOICE Act. For example, the report would change the Volcker Rule, while the CHOICE Act would repeal it. Some of these differences may be practical as opposed to philosophical. In addition a significant number of the recommendations in the report are directional but require further effort to work out the details. Whatever the outcome, it is clear that the process of rethinking the post-financial crisis regulatory system has begun in earnest.

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Because of the generality of this update, the information provided herein may not be applicable in all situations and should not be acted upon without specific legal advice based on particular situations.

Client Alert

June 9, 2017

U.S. House of Representatives Passes the Financial CHOICE Act of 2017

On June 8, 2017, the Financial CHOICE Act of 2017 (the "CHOICE Act") was passed on a party line vote by the U.S. House of Representatives, with nearly all Republicans voting in support and nearly all Democrats voting against passage.[1] The CHOICE Act was previously approved by the House Financial Services Committee ("Committee") on May 4, 2017 after two hearings were held on the bill.[2]

The CHOICE Act now moves to the U.S. Senate where it faces an uphill battle. Senate passage would require a 60 vote majority and Republicans control only 52 seats. There is no indication that any of the 46 Democrats, or 2 independents that caucus with the Democrats, will support the measure as passed by the House. As a result, it is likely that fundamental changes to the CHOICE Act would be required in order for it, or portions of it, to pass the Senate, be reconciled with the House bill and become law.

It is also anticipated that the Trump Administration will begin to weigh in on financial regulatory reform before a final bill is enacted. On February 3, 2017, the President issued Executive Order 13772 stating "Core Principles for Regulating the United States Financial System."[3] The Executive Order requires, among other things, the Secretary of the Treasury to issue a report identifying areas in the financial regulatory framework that should be amended. The Secretary of the Treasury has yet to publish the report, but it is expected soon and this report may help to shape the contours of any final bill.

In its current form, the CHOICE Act would make significant changes to the U.S. financial regulatory system mostly through repealing and restructuring much of the post-financial crisis framework established by the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Although the prospects for the CHOICE Act in its current form are uncertain, U.S. financial institutions, and foreign financial institutions with operations in the United States will want to keep abreast of the legislative process involving the CHOICE Act, as legislation, if any, that emerges is likely to impact their business.

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[1] The actual vote was 233-186; all 233 votes in favor came from Republicans and the votes against passage included 185 Democratic votes and 1 Republican vote. See http://clerk.house.gov/evs/2017/roll299.xml. The latest version of the Financial CHOICE Act of 2017, as amended, is available here: https://www.congress.gov/115/bills/hr10/BILLS-115hr10rh.pdf. A section-by-section summary of the legislation, prepared by the Republican majority on the Committee, is available here: https://financialservices.house.gov/uploadedfiles/050217_fc_memo.pdf. A comprehensive summary of the legislation, prepared by the Republican majority on the Committee, is available here: https://financialservices.house.gov/uploadedfiles/2017-04-24_financial_choice_act_of_2017_comprehensive_summary_final.pdf.

[2] For our client alert summarizing the hearing held by the Committee on April 26, 2017, please see: https://media2.mofo.com/documents/170427-financial-choice-act-of-2017.pdf.

[3] For the full text of Executive Order 13772, please see: https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states. President Trump also signed two presidential memoranda dealing with financial regulations on April 21, 2017: one directs the Secretary of the Treasury to assess the Financial Stability Oversight Council's process of designating banks and financial firms as "too big to fail"; the other directs the Secretary of the Treasury to review and report back on whether the federal government's orderly liquidation authority is useful to the U.S. economy and in line with the Administration's regulatory policy. Copies of the presidential memoranda are accessible here: https://www.whitehouse.gov/briefing-room/presidential-actions/presidential-memoranda.

Below is a general summary of some of the principal components of the CHOICE Act.[4]

- **Repeal of Orderly Liquidation Authority.** Section 111 of the CHOICE Act would repeal Title II of the Dodd-Frank Act which provides for the orderly resolution of systemically important financial institutions ("SIFIs"). After the financial crisis, an international consensus developed concerning the orderly resolution of SIFIs as an essential means to prevent future crises. The drafters of the CHOICE Act view the orderly liquidation authority ("OLA") as institutionalizing bailouts. The CHOICE Act would replace the OLA with a resolution process administered under the Bankruptcy Code and take away the ability of the FDIC to provide liquidity in the resolution process. It would also eliminate the role of the Federal Deposit Insurance Corporation ("FDIC") in resolution planning review.

- **The Leverage Ratio "Off-Ramp".** Title VI of the CHOICE Act would enable "qualifying banking organizations" or "QBOs" to opt out of federal laws and regulations that set capital and liquidity requirements and would prohibit federal banking agencies[5] from considering a QBO's effect on systemic risk or financial stability when reviewing certain applications. QBOs would also not be required to comply with most of the enhanced prudential standards established by Section 165 of the Dodd-Frank Act, including the risk committee, resolution planning, and stress testing requirements, among others. To qualify as a QBO, a banking organization would need to have an average leverage ratio of at least 10 percent. The term "average leverage ratio" is defined to mean the average of the banking organization's quarterly leverage ratios for each of the most recently completed four calendar quarters.

  The leverage ratio for determining whether a banking organization qualifies as a QBO would be calculated as Tier 1 capital divided by total assets (as reported on the banking organization's call report) *plus* off-balance sheet exposures, i.e., the supplemental leverage ratio for complex banking organizations.

  "Traditional banking organizations" would use the traditional leverage ratio, that is, Tier 1 capital divided by total assets as reported on the traditional banking organization's regulatory filings.[6]

  Banks that do not satisfy the conditions to be considered a "traditional banking organization" may find that maintaining a 10 percent supplemental leverage ratio is not an attractive alternative to complying with the regulations from which QBOs are exempt. As a result, if enacted in its current form, the "off-ramp" option may be of limited value.

- **Repeal of the Volcker Rule.** Section 901 of the CHOICE Act would repeal the Volcker Rule (i.e., Section 13 of the Bank Holding Company Act) in its entirety. The Volcker Rule was enacted as part of the Dodd-Frank Act and, subject to a series of exemptions and exclusions, generally prohibits banking entities from engaging in proprietary trading and from investing in, or sponsoring, hedge funds and private equity funds.

- **Repeal of the DOL Fiduciary Rule.** Section 841 of the CHOICE Act would repeal the Department of Labor's ("DOL") fiduciary rule which, when fully implemented, will require advisors to retirement plans to act as

[4] Please note that this Client Alert does not endeavor to summarize all of the important components of the CHOICE Act.

[5] The term "federal banking agencies" refers to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the FDIC.

[6] A "traditional banking organization" is defined in this section as a banking organization that: (A) has zero trading assets and zero trading liabilities; (B) does not engage in swaps or security-based swaps, other than swaps or security-based swaps referencing interest rates or foreign exchange swaps; and (C) has total notional exposure of swaps and security-based swaps of not more than $8 billion.

fiduciaries. The DOL would be prohibited from adopting any similar rule until after the U.S. Securities and Exchange Commission ("SEC") adopts a fiduciary standard for broker-dealers. In that event, the DOL would be required to adopt a rule substantially similar to the SEC rule.

- **Changes to the Financial Stability Oversight Council.** The Dodd-Frank Act established the Financial Stability Oversight Council ("FSOC"), an interagency council with responsibility to oversee systemic risk. FSOC has the authority to designate non-bank institutions as systemically important. The designation has the effect of subjecting such institutions to increased oversight and regulation. The CHOICE Act would repeal FSOC's authority to designate non-bank financial institutions and financial market utilities as systemically important. The CHOICE Act would also abolish the Office of Financial Research, which was established to support the work of FSOC by analyzing risks, performing essential research, and collecting and standardizing financial data across the U.S. financial system.

- **Changes to the Rulemaking Process.** Section 312 of the CHOICE Act would require any proposed rulemakings from the federal banking agencies (among others) to include at least the following analyses: (i) identification of the need for regulation and the regulatory objective; (ii) an explanation of why the private market or local government cannot address the problem; (iii) an analysis of adverse impacts; and (iv) a quantitative and qualitative cost benefit analysis; among other things. It also prohibits the enactment of a final rule where the quantified costs are deemed greater than the quantified benefits. This may inhibit the rulemaking process for agencies subject to this requirement, which may have difficulty quantifying the benefits of rules designed to protect against such things as systemic risk. The CHOICE Act would also require Congressional approval before rules that have an annual impact on the economy of $100 million or more take effect.

- **Review of Agency Actions.** Section 341 of the CHOICE Act would eliminate the *Chevron* doctrine with respect to judicial review of actions by the federal banking agencies (among others). The *Chevron* doctrine requires courts to provide significant deference to the determinations of federal agencies. The CHOICE Act would replace this deference with *de novo* review, meaning the agencies subject to this provision would not receive deference from federal courts with respect to their interpretations of federal law.

- **Changes to the Consumer Financial Protection Bureau.** Title VII of the CHOICE Act would restructure the Consumer Financial Protection Bureau ("CFPB") by moving it outside the Federal Reserve System, enabling its director to be removed at-will by the President, and renaming it as the Consumer Law Enforcement Agency. The CHOICE Act would also make fundamental changes to the authority of the renamed agency, including: stripping the agency's power to bring actions relating to unfair, deceptive, or abusive acts or practices ("UDAAP"); eliminating its enforcement authority over insured depository institutions; eliminating its rulemaking authority with respect to UDAAP, employee benefit compensation plans or persons regulated by the SEC or the Commodity Futures Trading Commission ("CFTC"), and small dollar loans; and preventing the agency from restricting arbitration agreements in connection with the offering or providing of consumer financial products.

- **Funding for Banking Agencies.** The CHOICE Act would subject certain agencies, which are currently funded outside the regular Congressional appropriations process, to be subject to such process. The agencies affected include: the new Consumer Law Enforcement Agency; the FDIC; the Office of the Comptroller of the Currency ("OCC"); the Federal Housing Finance Agency; the National Credit Union

Administration; FSOC; and the non-monetary policy functions of the Board of Governors of the Federal Reserve System ("Federal Reserve Board").

- **Requirements for International Processes.** Section 371 of the CHOICE Act would impose administrative burdens on federal financial regulatory agencies[7] with respect to their participation in international organizations. Such agencies would be required to issue notices, solicit public comment, and consult with the U.S. Senate's and House's committees of jurisdiction with respect to their participation in the standard-setting process of certain recognized international organizations (including, among others, the Basel Committee on Banking Supervision, the Financial Stability Board, and the International Association of Insurance Supervisors).

- **Minimization of Duplicative Enforcement Efforts.** Section 391 of the CHOICE Act would require the federal banking agencies (among others) to implement policies and procedures that would minimize duplication of efforts with other federal and state authorities when bringing an administrative or judicial action. Under the United States' dual-banking system, most banks answer to at least two regulatory agencies. This provision may help streamline enforcement actions where multiple agencies are involved.

- **Tailoring of Regulation.** Section 546 of the CHOICE Act would require the federal banking agencies (among others) to tailor future regulatory actions based on the risk profile and business model of each type of institution or class of institutions subject to the regulatory action. This section would also require the federal banking agencies (among others) to review all regulatory actions taken in the past seven years and to revise such regulatory actions to conform to the requirements of the CHOICE Act. A regulatory action is defined to mean "any proposed, interim, or final rule or regulation, guidance, or published interpretation." This may help ease the regulatory burden for smaller institutions.

As the CHOICE Act progresses through Congress, any legislation ultimately enacted into law will likely diverge significantly from the current bill. Nevertheless, we expect the CHOICE Act to play a part in framing the debate going forward.

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[7] The term "federal financial regulatory agencies" refers to the Federal Reserve Board, the FDIC, the OCC, the U.S. Department of the Treasury, the SEC, and the CFTC.

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Client Alert

May 23, 2017,
updated May 26, 2017

Living with the DOL Fiduciary Rule: Be Prepared for the June 9 Implementation Date

The first phase of the Department of Labor's ("DOL") new fiduciary rule ("Fiduciary Rule") is scheduled to be implemented on June 9, 2017. The Fiduciary Rule greatly expands the categories of persons who are deemed fiduciaries when dealing with retail retirement investors. It was adopted by the DOL in April 2016 together with new prohibited transaction exemptions: the Best Interest Contract Exemption ("BIC Exemption") and the Principal Transactions Exemption ("Principal Transactions Exemption").

To date, the Fiduciary Rule has survived all challenges. In response to an executive order issued by the President directing the DOL to re-evaluate the rule, the DOL postponed implementation of the more complex provisions of the BIC Exemption and the Principal Transactions Exemption until January 1, 2018, in order to afford the DOL more time to conduct the mandated re-evaluation. However, certain provisions were only delayed for 60 days and are scheduled to be implemented on June 9, 2017.

On May 22, 2017, the DOL announced it did not intend to seek any further delays of the June 9 implementation date. With less than three weeks to go before June 9, it appears unlikely that the initial phase of the Fiduciary Rule will be derailed.[1] For those market participants who have not yet prepared for implementation, the time has come to act.

What parts of the Fiduciary Rule will be implemented on June 9?

On June 9, 2017, the expanded definition of "fiduciary" will go into effect. In addition, fiduciaries who receive commissions or other variable compensation will be required to adhere to the Impartial Conduct Standards described below.

The detailed and controversial contract and disclosure provisions of the BIC Exemption and the Principal Transactions Exemption will not be implemented on June 9. As a result, starting on June 9, fiduciaries may make recommendations to retail retirement investors:

- As level fee fiduciaries who receive only a level fee (e.g., a fee based on a fixed percentage of assets under management) and no other fees in relation to the account (e.g., no 12b-1 fees);

  Or

- As fiduciaries to commissionable accounts, provided that they adhere to the Impartial Conduct Standards. Fiduciaries to commissionable accounts will not be required on June 9 to comply with the other provisions of the BIC Exemption and the Principal Transactions Exemption.

[1] The Financial Choice Act, currently pending in the House of Representatives, would block implementation of the Fiduciary Rule. However, the chances of such legislation being enacted in the next three weeks appear to be negligible given the current political situation in Washington. To date, all litigation challenges to the Fiduciary Rule have failed.

Who is a fiduciary under the new Fiduciary Rule?

Under the Fiduciary Rule, any person who for compensation provides advice about investments, investment strategies or investment counsellors will be deemed a fiduciary, even if the advice is episodic and not part of an on-going relationship.[2] Communications that are limited to educational information or to promoting the services of the financial institution would not be deemed investment advice. However, any statements regarding specific investment products or strategies that could reasonably be construed as suggesting action by the customer would be deemed investment advice. A recommendation to roll over assets in a retirement plan into a 401(k) or similar account would also be deemed investment advice, causing the person making the recommendation to be deemed a fiduciary.

Thus, most representatives of broker-dealers, as well as many insurance agents and some commercial bank employees, may well be deemed fiduciaries when discussing specific investment actions with retail retirement accounts.

What are the consequences of being deemed a fiduciary as of June 9, 2017?

Fiduciaries who continue to receive commissions or other variable compensation must comply with the Impartial Conduct Standards starting on June 9, 2017. These standards require that the fiduciary:

- Act in the "Best Interest" of the client.
- Charge only reasonable compensation.
- Avoid any misleading disclosures regarding investment products, fees and any material conflicts of interest that might affect the fiduciary.

While these principles may appear straightforward, their implementation should be carefully planned, as outlined below.[3]

What do I need to do to implement a "Best Interest" standard?

The "Best Interest" standard set forth in the Fiduciary Rule requires the fiduciary to act with the care and skill that a prudent person would employ in like circumstances, based upon the investment objectives, risk tolerance, financial circumstances and needs of the retirement investor. To meet this standard, fiduciaries should:

- Meet with their retail retirement investors on a regular basis and make sure they have an adequate understanding of the client's current circumstances and objectives.
- Conduct thorough diligence on all investment products offered to retail retirement investors. Such diligence should include comparing product features and fees with comparable products in order to be able to conduct a "Best Interest" analysis.
- Document the basis for the fiduciary's conclusion that a particular investment product is in the Best Interest of the client.
- Evaluate internal compensation arrangements to ensure that they do not improperly incentivize sales personnel to recommend products that are not in the best interest of retail retirement investors.

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[2] There is an exception for certain "institutional" retirement investors that are managed by a bank, broker, investment manager, insurance company or other independent fiduciary with at least $50 million under management.

[3] On May 22, 2017, the DOL issued Field Assistance Bulletin 2017-02, in which it stated that until January 1, 2018, the DOL will not pursue claims against fiduciaries who are working diligently and in good faith to comply with the Fiduciary Rule. This temporary enforcement policy would not apply to the rights or obligations of private litigants. In FAB 2017-02, the IRS also confirmed that the IRS has agreed not to apply the excise taxes of the Internal Revenue Code to transactions that are covered by the DOL's temporary enforcement policy.

- Train all sales personnel and supervisors to understand the differences between a "suitability" standard and a "Best Interest" standard.
- Monitor account activity with a view to detecting potential deviations from the new "Best Interest" standard.

How do I comply with the reasonable fees requirement?

In the release adopting the Fiduciary Rule, the DOL indicated that the reasonableness of fees should take account of:

- Prevailing "market" prices for the services provided, and
- The complexity of the investment product and the scope of monitoring required by the fiduciary.

Fiduciaries should maintain records demonstrating support for any determination that commissions or other fees are consistent with "market" standards. In addition, they must exercise vigilance with respect to products generating higher fees to ensure that such higher fees are justified.

How do I comply with the fair disclosure requirement?

Broker-dealers are already required by SEC and FINRA rules to make fair and balanced disclosure about investment products.[4] As fiduciaries, required disclosures must include information about the fiduciary's fees and material conflicts of interest.

What do level fee fiduciaries need to do?

Level fee fiduciaries are generally not subject to the Impartial Conduct Standards. However, the principles inherent in such standards apply equally to all fiduciaries. The key difference for level fiduciaries: the fee structure they use is deemed to align their interests with their clients, thereby making them less vulnerable to claims that their recommendations are not in the Best Interest of their clients.

Financial institutions or advisers choosing to act as level fee fiduciaries must not receive any form of variable compensation. They must refrain from charging their clients with fees other than level fees and they must not accept payments from third parties relating to services or products furnished to their fiduciary clients.

Moreover, when a level fee fiduciary provides advice to a client on rollovers, they are acting in a manner that may result in an increase in their level fees. Therefore, in such circumstances, level fee fiduciaries must comply with the Impartial Conduct Standards, and they should carefully document the basis for their recommendation.

What are the implications of the new standards for issuers and underwriters?

Issuers and underwriters need to understand how the new regulatory requirements will affect distributors who face retail retirement investors.[5] Distributors selling on a commissioned basis will need to evaluate the features and costs of investment products, comparing them to similar product offerings, in order to conclude whether or not the products can be recommended as being in the Best Interest of a retail retirement investor. This will inevitably put pressure on issuers and their advisers to keep costs down and to minimize or avoid third-party payments that might "taint" the product in the view of compliance personnel at the distributors.

Alternatively, products may be designed and/or marketed with the understanding that they will be distributed to retail retirement investors solely through level-fee fiduciary channels.

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[4] Some investment products, such as unregistered bank notes or certificates of deposit, are not necessarily subject to all of the detailed disclosure requirements set forth in SEC rules. However, most product manufacturers, especially when these products are planned for distribution to retail or retirement investors, utilize a comparable set of disclosures.

[5] For example, a variety of product manufacturers have updated their "know your distributor" diligence to identify those dealers who are selling products to retirement investors and have supplemented or updated their MSDA forms to address the application of the Fiduciary Rule.

The Principal Transactions Exemption strictly limits the categories of securities that may be sold on a principal basis to retail retirement investors. In addition, the BIC Exemption includes provisions that prevent fiduciaries from utilizing the exemption to sell securities issued by their affiliates to retail retirement investors.

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Summary of DOL Conflict Rule, BICE and Principal Transaction Exemption