Client Alert

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Treasury Department Urges Principles-Based Regulation of Money Managers; Delay of Implementation of Liquidity Risk Management and Fiduciary Rules

The U.S. Department of the Treasury's report on asset management and insurance recommends, among other things, a delay in implementation of the SEC's liquidity risk management rule and the Department of Labor's fiduciary rule.

The October 2017 report is the third of four that address the president's Core Principles to regulate the U.S. financial system, signed by executive order in February 2017. The report recommends that the Financial Stability Oversight Counsel (FSOC), which broadly oversees systemic risks to the U.S. financial system, back off on entity-based systemic risk evaluations of asset managers, and that the SEC focus on potential risks that arise from asset management and on strengthening the asset management industry as a whole.

This alert summarizes the provisions of the report that directly affect regulation of investment companies and investment managers. We do not address other provisions of the report relating to the Volcker Rule and insurance companies.

To start, the report includes a helpful, plain-English primer on how the U.S. regulates money managers and investment funds, summarizing the maze of regulations and regulators that apply to money managers, including the SEC, the IRS, the CFTC, and the DOL, not to mention state regulators. It highlights protections built in to the Investment Company Act of 1940, as amended, and the Investment Advisers Act of 1940.

The report then sets the stage for rethinking regulation of investment managers in a manner that favors principles-based regulation instead of detailed, rules-based regulations that Treasury believes are overly burdensome.

General Approach to Regulation of Money Managers

Treasury noted that, despite disruptive market events, mutual fund complexes have remained resilient in their ability to maintain total returns and meet redemptions.

The report also notes that, as assets under management (AUM) have continued to increase, so has the cost of regulatory compliance. Citing a Duff & Phelps report, the report says that money managers expect their cost of compliance to increase from four percent of total revenue to 10 percent of total revenue by 2022, and that many of these costs ultimately will be passed on to investors.

The report signals a likely change in direction by FSOC on prudential regulation of asset managers. In widely criticized reports, FSOC has suggested that asset managers present systemic risks to the financial system, and thus additional prudential regulation (e.g., capital and operating restrictions that are applied to banks and bank holding companies) would be appropriate. With regards to prudential regulation, Treasury emphasizes the difference between asset managers and banks, noting that "asset managers and investment funds, in contrast to banks, are not highly leveraged and do not engage in maturity and liquidity transformation to the same degree that banks do through the use of bank deposits and other forms of credit."

Treasury notes that, over the past 20 years, expense ratios for stock and bond funds have decreased, while "substantial asset flows are going to fewer asset managers and global competition has placed downward pressures on margins," especially for smaller investment advisers. The report notes that increased regulation, particularly implementation of compliance programs, has increased the downward pressure on margins, disproportionately affecting smaller asset managers and "reduc[ing] the ability of asset managers to reinvest for innovation and long-term growth."

Specific Recommendations

The following summarizes Treasury's specific recommendations concerning money managers.

- *Risks of money managers*. Rather than focus on entity-based evaluations, primary federal regulators should focus on potential risks arising from asset management products and activities, and on implementing regulations that strengthen the asset management industry as a whole.
    - Although FSOC maintains primary responsibility for identifying, evaluating, and addressing systemic risks in the U.S. financial system, Treasury recommends that FSOC look to the SEC to address risks through regulation within and across the asset management industry in the United States.
- *Stress testing of money managers*. Treasury does not support the prudential stress testing of investment advisers and investment companies as required by Dodd-Frank, and recommends that Congress repeal this requirement.
    - In the alternative, Treasury suggests that the stress testing provisions of Rule 2a-7 for money market mutual funds and Rule 22e-4 on liquidity risk management programs satisfy the spirit of Dodd-Frank's stress testing requirements.
- *Liquidity risk management*. The Treasury Department:
    - Supports the 15 percent limit on illiquid investments by mutual funds; and
    - Recommends that the SEC delay implementation of the Rule 22e-4 bucketing requirement, now scheduled for implementation in December 2018.
- *Derivatives use by investment companies*. Treasury generally supports the SEC's December 2015 rule proposal that would require funds to manage the risks of their derivatives activities (calling the proposal "an improvement from the current piecemeal approach"), but it expressed concerns about the rule's comprehensive, rules-based approach. In particular;
    - Treasury says that the proposed rule's specific portfolio limits could "unnecessarily restrict funds from using derivatives, even for hedging or for other risk mitigating purposes."
    - Treasury also finds the proposed rule's use of gross notional amount as a measure for derivatives exposure to be "problematic."
        - Specifically, the report notes that the proposed exposure-based portfolio limit would require a fund to limit its aggregate exposure to 150 percent of the fund's net assets calculated based on the aggregate gross notional amount of the fund's derivatives transactions, but that a high gross notional exposure of a fund's portfolio is not necessarily correlated with leverage or risk levels.

    - Also, Treasury criticizes use of gross notional amount as a measure for derivatives exposure risks because it does not take into account the beneficial effects of using derivatives in portfolio management.
  - The report also finds that the proposed rule's limiting of qualifying coverage assets to cash and cash equivalents under its requirement that investment companies segregate an amount of qualifying coverage assets for derivatives so that they can meet their obligations in a stress scenario, could require funds to hold more of those assets than they would otherwise. This could potentially reduce investment returns and cause tracking errors for funds that follow indexes.
  - With these concerns in mind, Treasury recommends that the SEC:
    - reconsider what, if any, portfolio limits should be part of the rule and, if any such limits are adopted, base them on significantly more risk-adjusted measures of a fund's derivatives than does the proposed rule;
    - reconsider the scope of assets that funds should consider to be qualifying coverage assets for purposes of the asset segregation requirement; and
    - examine the derivatives data that funds will report starting next year under new rules adopted by the SEC in October 2016, which require almost all funds pursuant to Form N-PORT to report information about their monthly portfolio holdings, including extensive information on derivatives investments, and publish an analysis based on empirical data regarding funds' use of derivatives.
- *Exchange-traded funds*. Treasury recommends that the SEC adopt a "plain vanilla" ETF rule, rather than continue to rely on time consuming and costly individual exemptive orders. The rule would codify the most common features of the outstanding exemptive orders issued to transparent, index-based ETFs.
- *Business continuity and transition planning*. While it strongly supports "robust business continuity planning," Treasury recommends that the SEC withdraw its June 2016 proposed rules, and instead rely on existing principles-based rules now in place.
- *Dual SEC/CFTC registration*. Treasury targets dual regulation by the SEC and the CFTC of investment companies and investment advisers as unnecessary and duplicative regulation.
  - Treasury recommends repeal of the 2012 CFTC rule amendments that exempted investment companies and their advisers from registration only if their commodity interest transactions (other than those used for bona fide hedging purposes) do not exceed two alternative de minimis tests for commodity interest trading, returning the investment company exemption to its pre-2012 form (without a de minimis limitation).
    - Treasury notes that many SEC-registered mutual funds do not resemble or compete with traditional commodity pools, so the limitation on the exemption for investment companies is too restrictive.
    - Acknowledging that there may be some SEC-registered mutual funds that resemble commodity pools, Treasury recommends that the CFTC and SEC together identify a "single regulator" to regulate these entities.
  - Treasury also recommends that the CFTC exempt private funds and their advisers from the requirement to register as commodity pool operators (CPOs) when fund advisers are registered with the SEC.

- *Prospectus delivery*. Treasury encourages the SEC to finalize its proposed rule to modernize its shareholder report disclosure requirements and permit the use of implied consent for electronic delivery of registered fund disclosures. Investors, however, should retain the right to opt out of electronic delivery.
- *Asset manager reporting and disclosure requirements*. Treasury states that "regulators should work together to rationalize and harmonize the reporting regimes."
- *Department of Labor fiduciary rule*. Treasury supports the current efforts at the DOL to re-examine the implications of the fiduciary rule, and recommends that DOL delay full implementation of the rule pending further study. It recommends participation by the SEC and other regulators in crafting a comprehensive rule.

Money market funds. Treasury sidestepped any recommendations on regulation of money market funds. It simply summarized the history of recent rule changes.

Our Take

Treasury's recommendations suggest a shift from FSOC's prior view that money managers present systemic risks. Instead, Treasury focuses on improving prudential regulation by the functional regulators (that is, the SEC and the CFTC).

The recommendations suggest that the SEC and CFTC reconsider pending proposals (e.g., derivatives regulation); delay implementation of final rules (e.g., liquidity risk management and the DOL fiduciary rule); and take a more principles-based approach, rather than a prescriptive rules-based approach, toward regulating investment companies and investment advisers.

Notably, Treasury traced the recent history of money market reform, but stopped short of recommending any changes to the SEC's 2014 rules that required "prime" (non-government) institutional money market funds to float their NAV rather than maintain a $1 net asset value. Instead, it noted that, in the 10-month period ending October 31, 2016, prime and tax-exempt money market funds experienced a decrease of $1 trillion in assets, while government money market funds saw an increase of $968 billion during that same period. This discussion sets the stage for Treasury to make further recommendations.

If Treasury has its way, the SEC will not finalize the proposed derivatives rules in their current format. We believe it is likely that the SEC will repropose a more principles-based version, in line with the Treasury's recommendations.

Finally, we anticipate that the SEC and CFTC are likely to ease the pace of prescriptive regulatory proposals in light of Treasury's recommendations. Of course, both the SEC and the CFTC operate as independent commissions, and we expect them to proceed independently to achieve their stated missions. But Treasury has provided a blueprint for the SEC and CFTC to take a principles-based regulatory approach that, we hope, will continue to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation, all without undue costs that investors would ultimately bear.

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