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Treasury's Third Report on Financial System Regulation Focuses on the Asset Management and Insurance Industries

Brendan C. Fox, Robert H. Ledig, and Thomas P. Vartanian*

The U.S. Department of the Treasury recently released a report examining the regulatory framework for the asset management and insurance industries. In this article, the authors explain the Treasury's recommendations that are related to the asset management industry.

The U.S. Department of the Treasury ("Treasury") recently released a report examining the regulatory framework for the asset management and insurance industries ("Report").[1] The Report is the third in a series of four reports that Treasury has undertaken in response to Executive Order 13772, which sets forth seven core principles for financial services regulation.[2] Each report focuses on different segments of the financial services industry and examines the current regulatory framework, with the goal of identifying areas out of alignment with the core principles and making recommendations to align these areas.

The Report includes several recommendations for legislative and regulatory action in the asset management and insurance industries. Treasury believes these actions will lead to enhanced systemic risk management, more efficient regulation, strengthened U.S. engagement in international regulation, economic growth, and more informed investors. However, it is unclear what effect the Report and Treasury's legislative and regulatory recommendations will have, if any, given the current practical requirement to obtain 60 votes to move

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[1] A Financial System that Creates Economic Opportunities: Asset Management and Insurance (Oct. 26, 2017). In some instances, this article tracks the Report without the use of quotation marks.

[2] Presidential Executive Order on Core Principles for Regulating the United States Financial System, Executive Order 13772 (Feb. 3, 2017).

legislation in the Senate (which would require bipartisan support) and the status of the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission ("CFTC") as independent regulatory agencies.

Although the Report includes recommendations related to insurance regulation generally, this article focuses on Treasury's recommendations in the Report that are related to the asset management industry.

SYSTEMIC RISK

The Report highlights key differences between the asset management industry and prudentially regulated institutions such as banks, including that asset managers and investment funds: are less highly leveraged than banks; do not engage in maturity and liquidity transformation to the same extent as banks; and do not bear the risk when assets decline in value, because such risks are instead borne by fund investors. The Report notes that, following review of the asset management industry by the Financial Stability Oversight Council ("FSOC"), the FSOC resolved to focus on asset management products and activities, rather than entity-specific evaluations. The Report also describes the extensive substantive regulations to which registered investment companies are already subject under the Investment Company Act of 1940 ("1940 Act") and the SEC's rules thereunder.

In light of the FSOC's findings and key differences between the asset management industry's risk profile and that of prudentially regulated institutions, the Report recommends that regulators focus on particular products or activities in the industry that may give rise to systemic risk, rather than engaging in entity-based systemic risk evaluations or potential Systemically Important Financial Institution ("SIFI") designations of asset managers and investment funds. Shortly after the release of the Report, Treasury issued a report to the President on SIFI Designations ("SIFI Report").[3]

The SIFI Report expresses a strong preference for an activities-based response to financial stability concerns, and recommends that the FSOC apply a much more rigorous approach to determining whether a company presents a threat to financial stability warranting a SIFI designation, including requiring a cost-benefit analysis that finds the expected benefits of a designation outweigh its costs.

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[3] Treasury Department, Financial Stability Oversight Council Designations, Report to the President pursuant to the Presidential Memorandum of April 21, 2017 (Nov. 17, 2017).

The Report also recommends that, while the FSOC should maintain primary responsibility for addressing systemic risk in the U.S. financial system, the SEC should remain the primary federal regulator of the U.S. asset management industry.

STRESS TESTING

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") requires registered investment companies, and registered investment advisers with more than $10 billion in consolidated assets, to perform annual stress testing and report their results to both the SEC and the Federal Reserve Board. This provision has not been implemented by the SEC. Citing the SEC staff's acknowledgment of significant implementation challenges for asset management firms, as well as existing SEC regulations designed to address potential risks to mutual funds during stressed market conditions (including amendments to the rules governing money market funds and the adoption of a liquidity risk management rule), the Report recommends that Congress amend the Dodd-Frank Act to eliminate the stress testing requirement for investment advisers and investment companies.

LIQUIDITY RISK MANAGEMENT

Stressed liquidity conditions can pose a substantial risk to financial markets, as demonstrated during the financial crisis in 2008. Policymakers and regulators have been focusing on reducing the risks of rapid investor redemptions and the potential impact of such redemptions on fund investors and market conditions. The SEC adopted Rule 22e-4, which subjects open-end funds to a 15 percent limitation on illiquid investments. The rule also requires open-end funds, including exchange-traded funds ("ETFs"), to establish a liquidity risk management program. Treasury supports the 15 percent limitation under Rule 22e-4; however, Treasury recommends that the SEC postpone implementation of certain portions of the rule. Under the rule, certain open-end funds, including ETFs that meet redemptions using more than a "*de minimis*" amount of cash, must classify (or "bucket") their assets into one of four categories. Such funds would be required to monitor the liquidity risk of their portfolio and determine a minimum percentage of their assets that must be invested in investments under the "highly liquid" category. Treasury recommends that the SEC postpone this classification requirement and ultimately replace it with an alternative "principles-based approach."

DERIVATIVES

In December 2015, the SEC proposed new rules concerning the use of derivatives by mutual funds, ETFs and closed-end funds under certain conditions, and consistent with the 1940 Act's restrictions on the issuance of senior securities. The proposed rules, if enacted, would effectively limit funds' use of leverage obtained through derivatives, by establishing exposure-based or risk-based portfolio limits. The proposed rules also would require a fund to segregate qualifying coverage assets (*i.e.*, cash and cash equivalents) based on derivatives exposure, and establish a derivatives risk management program if the fund uses more than a limited amount of derivatives. Treasury generally supports the SEC's efforts to modernize the regulation of derivatives for funds, but has concerns with the current proposed rules. Specifically, Treasury indicates that the proposed use of gross notional amount to measure a fund's derivatives exposure and corresponding risk level is unreliable.[4] Further, Treasury suggests that the proposed rules' limitation of qualifying coverage assets to cash and cash equivalents could potentially reduce investment returns and cause tracking errors for index-based funds. Treasury recommends that the SEC reconsider what, if any, portfolio limits should be part of the rules, as well as the scope of assets that would be considered qualifying coverage assets for purposes of the asset segregation requirement.

EXCHANGE-TRADED FUNDS

The ETF market has been growing in recent years and now provides a broad range of investment options for investors. However, the current process for sponsors to launch an ETF that has not been listed for trading on a national exchange involves significant time and expense and can be unpredictable. Under the current process, an ETF sponsor must first obtain an exemptive relief order from the SEC to operate an ETF under the 1940 Act and other federal securities laws. In 2008, the SEC proposed a rule to streamline this process, but it did not adopt a final rule. The proposed rule generally would have codified the exemptive orders previously issued by the SEC, and would have permitted new ETFs to operate without obtaining exemptive orders under specified

[4] The proposed rules 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. Treasury believes a high gross notional exposure of a fund's portfolio is not necessarily correlated with leverage or risk levels. Absent a clearly defined connection between gross notional amounts of derivatives and leverage, and evidence of unacceptable levels of risk associated with the use of derivatives for leverage, Treasury sees the proposed rules as unreliable.

conditions. Treasury recommends that the SEC move forward with a "plain vanilla" ETF rule and establish a single process for ETFs that allows new registrants to access the market without the cost and delay of obtaining exemptive orders.

BUSINESS CONTINUITY AND TRANSITION PLANNING

Treasury views business continuity and transition planning as playing an important role in the operation of investment companies and investment advisers in times of major market disruption. In 2003, the SEC adopted Rule 206(4)-7 under the Investment Advisers Act of 1940 ("Advisers Act") and Rule 38a-1 under the 1940 Act to require investment advisers and investment companies to maintain business continuity plans as part of their compliance policies and procedures. Under these rules, investment advisers and funds are required to adopt and implement written compliance policies and procedures, including business continuity plans. However, the advisers and funds have flexibility in implementing a business continuity plan that is appropriate for the particular entity. Nonetheless, in June 2016, the SEC proposed a new Rule 206(4)-4 under the Advisers Act, requiring new policies and procedures that contain a number of prescriptive requirements for the content of business continuity and transition plans. Treasury believes that these requirements will increase the costs of compliance and that the proposed rule is unnecessarily burdensome in light of the current requirements under Rule 206(4)-7 and Rule 38a-1. Accordingly, Treasury recommends that the SEC withdraw the proposal.

REDUCING BURDENSOME COMPLIANCE PROCEDURES

Under a 2012 amendment to CFTC rules, some advisers to SEC-registered investment companies that operate in a manner similar to commodity pools are required to dually register with the CFTC. Consequently, such advisers are subject to the CFTC's reporting and regulatory obligations in addition to the SEC's regulations. Treasury recommends that the CFTC and the SEC identify a single regulator for *de facto* commodity pools,[5] with the goal that oversight of these entities will either remain with the SEC or be transferred to the CFTC and the National Futures Association. Some advisers to private funds are also subject to dual oversight. Thus, Treasury recommends that the CFTC amend its rules to exempt private funds and their advisers from registration as commodity pool operators if the advisers are subject to regulatory oversight by the SEC.

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[5] "*De facto* commodity pools" refers to certain investment companies marketed to retail customers as commodity futures investments, but not subject to CFTC or NFA regulation because the entity claimed an applicable exemption under the Commodity Exchange Act.

Registered investment companies are subject to an extensive set of disclosure requirements under various regulations. Under many of these requirements, investment companies must provide the disclosures in paper by mail, which can be costly, unless the investment company obtains consent for electronic delivery. Treasury recommends that the SEC explore areas where it could be appropriate to deliver information to investors through an electronic medium with implied consent, provided such delivery would be consistent with investor protection. Specifically, Treasury recommends that the SEC finalize its proposed rule[6] to modernize its shareholder report delivery requirements and permit the use of implied consent for electronic disclosures. However, Treasury believes that investors should retain the choice to continue to receive paper disclosures.

In past reports, Treasury recommended changes to Section 619 of the Dodd-Frank Act, known as the Volcker Rule. The Volcker Rule generally prohibits insured depository institutions, certain foreign banking organizations, and their affiliates (collectively, banking entities) from: (i) engaging in certain proprietary trading activities; and (ii) sponsoring or holding ownership interests in "covered funds" (generally funds that rely on an exemption from investment company registration under section 3(c)(1) or 3(c)(7) of the 1940 Act). Treasury believes that the current restrictions are overly complicated and burdensome, especially regarding the definitions of "banking entities" and "covered funds," making it difficult for banking entities to hedge their risks and conduct market-making activities. Thus, Treasury recommends that the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, SEC and CFTC (collectively, "Regulators") continue to refrain from enforcing the Volcker Rule's proprietary trading restrictions against foreign private funds that are not "covered funds" under the rule, until a permanent solution to the identified challenges is implemented.

Similarly, Treasury recommends that the Regulators allow banking entities other than depository institutions and their holding companies to share a name with funds they sponsor, provided that the separate identity of the fund is clearly disclosed to investors. Treasury also recommends that Congress pass legislation to reduce these burdens by revising the Volcker Rule's definition of "banking entity" under the Dodd-Frank Act to encompass only insured depository institutions, their holding companies, foreign banking organizations, and affiliates and subsidiaries of such entities that are at least 25 percent owned or otherwise controlled by such entities.

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[6] Investment Company Reporting Modernization (May 20, 2015), 80 Fed. Reg. 33590 (June 12, 2015).

INTERNATIONAL ENGAGEMENT

Because many U.S. asset managers operate global businesses, Treasury believes that a level playing field with consistent regulatory standards is needed. As such, Treasury supports a continued effort to position the United States in the leading role in international standard-setting bodies such as the Financial Stability Board ("FSB") and International Organization of Securities Commissions, and to promote transparency and accountability in such organizations. Specifically, Treasury recommends that U.S. representatives at the FSB work to revise the FSB's Global Systemically Important Financial Institution framework to appropriately account for the different ways in which industry participants are structured and manage risks. Furthermore, Treasury recommends that the FSB move away from using the term "shadow banking" to describe registered investment companies and their investment advisers, as Treasury believes the term "shadow" implies insufficient regulatory oversight or disclosure.

IMPACT OF DOL FIDUCIARY RULE ON RETIREMENT SAVINGS

The U.S. Department of Labor ("DOL") on April 6, 2016 released the final version of its "investment advice" regulation ("Regulation") and accompanying prohibited transaction exemptions (collectively with the Regulation, "Fiduciary Rule"), relating to the definition of "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code of 1986 ("Code"). The Regulation broadens the definition of "fiduciary" under ERISA and the Code and applies not only to retirement plans that are subject to ERISA, but also to individual retirement accounts ("IRAs") and certain other non-ERISA plans. In connection with the Regulation, the DOL created new prohibited transaction exemptions and amended existing exemptions to allow fiduciaries to continue certain traditional compensation arrangements.[7] Compliance with all of the provisions of the Regulation and only certain conditions of the exemptions was required as of June 9, 2017. Compliance with the remaining conditions of the exemptions has been delayed until July 1, 2019.

In the Report, Treasury recognizes concerns that the Fiduciary Rule will have unintended consequences, including: limiting access to financial advice for retirement products; disrupting the retirement services industry; and increasing costs and fees associated with retirement products in general. Treasury states that it would be appropriate to delay full implementation of the remaining

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[7] Such compensation arrangements include: commissions; payments made pursuant to a plan adopted under 1940 Act Rule 12b-1; and revenue sharing payments.

conditions of the exemptions until relevant issues, including the costs of the Fiduciary Rule, have been evaluated and addressed. Treasury supports SEC and DOL coordination in developing standards of conduct for financial professionals advising retirement investors.

THE SEC AND THE INSURANCE INDUSTRY

The Report generally requests that the SEC "take steps to improve the efficiency and effectiveness of the regulation of insurance products under its jurisdiction" and specifically provides that these goals can be attained, at least in part, by: permitting variable annuity summary prospectuses; allowing mutual funds to provide statutorily required shareholder reports on the internet; and developing new accounting standards for insurance business models.

Variable annuities must be registered with the SEC and sold with a prospectus, and holders of variable annuities must receive an annual prospectus update. Further, statutorily required shareholder reports are currently required to be delivered by mail, which is a costly process. The Report states that these requirements result in lengthy and dense information not readily understood by, or helpful to, the recipient. In May 2015, the SEC proposed Rule 30e-3 under the 1940 Act, which would allow mutual funds to provide statutorily required shareholder reports on the internet. Treasury recommends that the SEC "prioritize annuity-related disclosure reform by proposing a rule permitting a variable annuity summary prospectus and a streamlined prospectus update." Additionally, Treasury recommends that the SEC finalize Rule 30e 3. The Report states Treasury's belief that summary prospectuses and less burdensome reporting requirements would provide holders of variable annuities with the appropriate level of disclosure in a more understandable and readily accessible fashion.

The Report addresses the SEC's accounting requirements for the insurance industry in addition to the SEC's disclosure requirements. Currently, the SEC collaborates with the Financial Accounting Standards Board and International Financial Reporting Standards (which set financial accounting and reporting standards for public and private companies and nonprofit organizations) to develop financial accounting and reporting standards. The Report suggests that this process does not sufficiently account for an insurance company's unique business model. Treasury recommends that the SEC engage with the insurance industry and its other regulators to assess how the SEC's current accounting standards affect the insurance industry.

CONCLUSION

If implemented, the recommendations in the Report could have significant effects on the regulatory framework for the asset management and insurance industries. The Report includes both legislative and regulatory recommendations. With respect to legislation, the current practical requirement to move legislation in the Senate means that broad regulatory reform is unlikely to pass without some degree of Democratic support. With respect to regulation, it is unclear to what extent other agencies—such as the SEC, CFTC, and DOL—agree with Treasury's recommendations. In particular, the SEC and CFTC are independent agencies and are not required to act at the direction of the Trump Administration. It is therefore unclear what effect the Report ultimately will have on financial regulation in the United States.