

The logo for K&L GATES, featuring the text in white on an orange rectangular background.

K&L GATES

A blurred background image of a server rack with glowing lights in blue, yellow, and green.

2016 INVESTMENT MANAGEMENT CONFERENCE

Industry Developments Hot Topics

Michael W. McGrath, Partner, Boston

C. Todd Gibson, Partner, Boston/Pittsburgh

Robert L. Sichel, Partner, New York

Derek N. Steingarten, Partner, New York

INDUSTRY GROWTH

- The number of investment advisers registered under the Investment Advisers Act of 1940 has risen by 17% in the last two years.
- Collectively they manage \$70 trillion in assets, an increase of more than \$40 trillion over the last decade.
- In response, the SEC has recently increased by 20% the number of examiners that monitor investment advisers and investment companies.
- New developments in Robo-Advice Platforms, Fintech and Exchange-Traded Funds

INCREASED REGULATION, REPORTING AND ENFORCEMENT

- SEC Changes Regulation for Registered Advisers and Registered Funds
 - Final Rule on Liquidity Risk Management Programs for Registered Funds
 - Proposed Rules for Adviser Business Continuity and “Living Will” Transition Plans
 - Proposed Derivatives Rule
 - Final Amendments to Form ADV for Disclosure of Separately Managed Accounts
 - Continued Emphasis on “Distribution-in-Guise”

- DOL Fiduciary Regulation
 - Already adopted and effective
 - Compliance date April 2017
 - Political Open question

- SEC Enforcement
 - Record-breaking number of new enforcement actions, whistleblower awards
 - Whistleblower Developments – Rule 21F-17 and Anti-Retaliation Cases
 - Cybersecurity Enforcement Actions

POST-ELECTION – A NEW DIRECTION?

- President Trump's agenda involves reduced regulation of the financial services industry and changes in enforcement
 - Financial Choice Act / reforms to the Dodd-Frank Act
 - Open Questions about Status of Pending Rule Proposals
 - A proposed Executive Order to strike two regulations for each one approved

- Intense Pressures at the SEC
 - Departing senior staff
 - A proposed hiring freeze
 - Questions about the existing nominees



Robo-Advisers



ROBO-ADVISERS AND REGULATORY RESPONSES

- “Robo-advisers” implement multiple, overlapping business models:
 - Direct client interaction
 - Favored by younger investors comfortable with social media and virtual relationships
 - Favorable fee structure
 - Traditional advisers relying on robo-advisers for certain functions
 - Refer clients to robo-advisers for certain aspects of portfolio management
 - Incorporate robo-advisers into traditional financial planning
 - Use of robo-advisers in providing investment advice
 - portfolio construction
 - automated tax-loss harvesting
 - portfolio rebalancing
 - “white label” / customized robo-advice platforms

PROLIFERATION OF ROBO-ADVISERS

- Cerulli Associates (2015): assets managed by robo advisers to rise 2,500% between 2015 and 2020, to \$489 billion
- Tiburon Strategic Advisors (2016): 51 robo advisers in the market, collectively managing close to \$250 billion
- InvestmentNews*:
 - 7.3% of independent advisory firms use a robo-advice platform
 - 63.2% of independent BDs plan to offer robo-advisory services over the next two years
 - Of those, 50% plan to do so by the end of 2016
- Independent robo-advisers (e.g., Betterment, Wealthfront) receive a lot of press, but represent only 3% of digital wealth management AUM**

*Liz Skinner, Robo-Advisers Demand Attention, InvestmentNews, December 20, 2015.

**“The hard truth about the rise of robo advisers,” Financial Planning, October 3, 2016.

SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

“While automated investment tools may offer clear benefits—including low cost, ease of use, and broad access—it is important to understand their risks and limitations before using them.”

“Investors should be wary of tools that promise better portfolio performance.”

SEC INVESTOR ALERT: AUTOMATED INVESTMENT TOOLS (MAY 8, 2015)

1. Understand any terms and conditions.
 - Ask an automated investment tool sponsor whether it receives any form of compensation for offering, recommending, or selling certain services or investments.
2. Consider the tool's limitations, including any key assumptions.
 - Be aware that an automated tool may rely on assumptions that could be incorrect or do not apply to your individual situation.
 - Automated investment tool may be programmed to consider limited options.
3. Recognize that the automated tool's output directly depends on what information it seeks from you and what information you provide.
4. Be aware that an automated tool's output may not be right for your financial needs or goals.
5. Safeguard your personal information.
 - Collection of personal information for purposes unrelated to the tool.
 - Beware of phishing and other scams.

FIDUCIARY STATUS OF ROBO-ADVISERS

“What would a fiduciary duty mean to a robo-adviser? Or suddenly, is there no fiduciary duty if it's automated advice?”

-Commissioner Kara Stein, Investment Adviser Association Compliance Conference (March 10, 2016)

- Duty of Loyalty
 - Conflicts of interest and disclosure
 - Standard criteria for determining the appropriate investments drawn from a defined universe of potential investments
 - Disclosure of inherent and latent conflicts of interest
- Duty of Care
 - Competence and suitability of recommendations
 - Suitability is the real issue--Knowledge of client's financial status and investment needs may not be sufficiently established by an automated, inflexible set of questions
- Effectiveness of robo-adviser disclaimer of consideration of retail investor's entire financial situation?
- Impact of ERISA?

The logo for K&L GATES, featuring the text in white on an orange rectangular background.

K&L GATES

A blurred background image of a server rack with glowing lights in blue and yellow.

2016 INVESTMENT MANAGEMENT CONFERENCE

European Investment Management Updates

C. Todd Gibson, Partner, Boston/Pittsburgh



Brexit



HOW DOES THE UK EXIT?

- Article 50 of the Lisbon Treaty
- New Brexit task force created
- Oliver Robbins appointed as the Permanent Secretary to the new team
- EU split roles for exit (EC) and continued access (EU Council)
 - Didier Seeuws, former chief of staff to former European council president Herman Van Rompuy
 - Michel Barnier (and Martin Selmayr, current EC president Juncker's chief of staff)
- European Parliament also has a role
 - Guy Verhofstadt, former Belgian prime minister



ARTICLE 50 PROCESS

- Art 50 of the Treaty on European Union.
- Notification in the hands of the UK.
 - Recent court decision indicates Act of Parliament required – higher court ruling in January?
 - Can it be “deemed” by EU?
- Up to two-year period for **withdrawal** to be negotiated and take effect.
- Negotiations between the UK and the European Commission, as EU negotiator, based on guidelines issued by the European Council and in accordance with article 218(3) of the Treaty on the Functioning of the European Union (TFEU).
- Can be extended by agreement of **all** EU member states.
- If no extension, UK automatically ceases to be a member of the EU at the end of two years.

How Could the UK's Relationship With the EU Change?

The UK already opts out from parts of the EU. If it leaves, its future could look like Norway, Switzerland, or Turkey, nonmembers with partial participation in the EU.

	 FULL PARTICIPATION  PARTIAL PARTICIPATION <small>Indicates a negotiated special arrangement.</small>	 SINGLE MARKET	 FREE MOVEMENT OF PEOPLE	 CONTRIBUTE TO EU BUDGET	 VOTE ON EU LAW	 EUROZONE	 "EVER CLOSER UNION"
 STANDARD EU*							
 CURRENT UK MEMBERSHIP							
POTENTIAL POST-BREXIT SCENARIOS							
 EUROPEAN ECONOMIC AREA (NORWAY)							
 BILATERAL DEAL (SWITZERLAND)							
 CUSTOMS UNION (TURKEY)							

COUNCIL OF FOREIGN RELATIONS

*Except for the UK Sources: UK Government, *The Economist* Credits: James McBride, David Foster

IMPACT OF BREXIT ON FUNDS AND MANAGERS

- UCITS and AIFMs
- Cross-border advisory/management services (MiFid services)
- Solvency II, CRD, myriad of other EU laws and directives incorporated into UK laws (competition, immigration, etc.)
- Potential outcomes
 - EEA (Norway) – Single-market access for goods and services
 - EFTA (Switzerland) – Single-market access – goods only
 - Something else?

BREXIT PRACTICAL CONSIDERATIONS

- NO CHANGE FOR THE TIME BEING, but now is time for detailed contingency planning
- Consider exposure to EU markets
- What is your current licensing strategy and does it rely on passporting?
- Where are your operations and staff based?
- It's not just about passporting! *UK laws are based on EU laws*

HOW SHOULD THE INDUSTRY RESPOND?

- Raise awareness with EU/Eurozone of the importance of the UK as a partner outside of the EU.
- Build coalitions of stakeholders throughout the EU to communicate the importance of a balanced deal with the UK and to reinforce the above.
- Promote a set of policies to improve the UK's competitive position (for example, tax, skilled migration, targeted removal of regulations etc).
- Propose solutions and options that remove uncertainty – what is realistically achievable?
- UK debate should recognize the very real concerns of Eurozone leaders of the risk of contagion from the Brexit result.
- The negotiations will be a multi-party process with no one party able to leverage its position.
- Work with industry trade groups.
- Get involved with the UK's Brexit task force.

EXAMPLES

- US or EU manager has Irish ManCo with Ireland-domiciled UCITS passported into UK
- US or EU manager with UK-based UCITS for local market and passported throughout EU
- US or EU manager with UK-based UCITS for local UK market
 - *UK Non-UCITS Retail Scheme (NURS)?*

NURS 101

- **UK (FCA) authorized fund**
 - *must be organized in the UK as either an open-ended investment company or unit trust.*
- **May be marketed to retail investors in UK**
 - *Non-UCITS, so no UCITS passport*
- **Subject to the AIFMD; not UCITS**
 - *Although they have more in common with UCITS, NURS are subject to the AIFMD.*
 - *NURS could benefit from the AIFMD passport to market to professional clients in the EEA outside the UK, subject to NPPRs*
- **Investment powers / restrictions similar to UCITS but with additional flexibility, e.g.:**
 - *Up to 100% NAV in real estate*
 - *Up to 10% NAV in transferable securities of single issuer (cf 5/10/40 rule for UCITS)*
 - *Up to 20% NAV in unlisted securities (cf 10% limit for UCITS)*
 - *Up to 35% NAV in CIS (cf 20% for UCITS)*
 - *For “feeder NURS”, up to 100% in a UCITS or other NURS*
 - *For NURS authorized as “fund of alternative investment funds” (“FAIFs”, up to 100% NAV in unregulated funds meeting certain criteria)*
- **KIID / PRIIPs**
 - *A NURS will need to produce a short disclosure document accompanying the prospectus.*
 - *FCA permits NURS to produce a “NURS KIID”, which is effectively the same as the KIID for UCITS.*
 - *Both UCITS and NURS are within the scope of the PRIIPs Regulation, but it remains unclear whether NURS will benefit from the same exemption as UCITS which last until 31 December 2019.*



UCITS

UCITS V - REMUNERATION

■ Remuneration

- Alignment of UCITS manager remuneration with AIFMD
- Applies to all compensation paid to all staff whose activities have a material impact on the risk profile of the UCITS
 - Assessment of potential “material influence” of the staff member on the UCITS’s risk profile
 - Executives, directors, senior management, portfolio managers, traders, CIOs
 - What about compliance officers, internal counsel, sales persons, chief risk officer?
- Application to “delegates” – if not subject to an equivalent regulatory regime (AIFMD/CRD), “appropriate contractual arrangements” should be put in place with the delegate
- Proportionality applies and may allow for disapplication of some of the restrictions
 - Compliance only required in a way and to an extent that is appropriate to the manager’s size, internal organization, and the nature, scope and complexity of activities
- ESMA to issue additional details in Level 2 guidelines regarding applicability to staff, proportionality

UCITS V - REMUNERATION

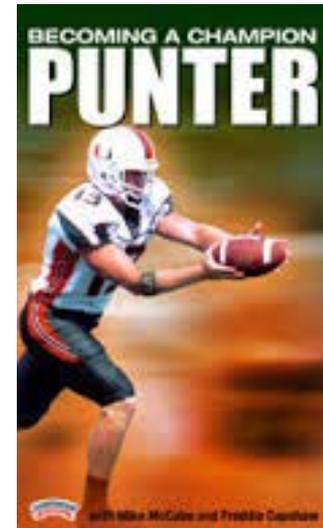
- Remuneration (continued)
 - Variable Remuneration - Shares
 - 50% paid in UCITS shares (or certain other), with vesting periods
 - Does not apply if management of UCITS is less than 50% of the total assets managed by the management company
 - Variable Remuneration – Bonuses
 - 40% deferral over minimum of 3 years (or recommended holding period of UCITS concerned)
 - Deferral higher where variable compensation is a large component of total compensation

UCITS V - PROPORTIONALITY

- General principle requiring managers to comply with remuneration rules *“in a way and to the extent that is appropriate to their size, internal organization and the nature, scope, and complexity of their activities.”*
- ESMA consultation proposed to interpret proportionality to allow dis-application of certain requirements in some circumstances (consistent with AIFMD)
 - Inconsistent with EBA application of similar rules under CRD

UCITS V – ESMA FINAL GUIDELINES REPORT

- Issued 31 March
- Most significant change to initial draft was lack of guidance regarding application of proportionality principles
- ESMA sent a letter to EC and EP –
 - Proportionality should apply, but....
 - Legislative changes may be necessary





AIFMD



AIFMD THIRD COUNTRY UPDATE

- July 2016 – ESMA issues advice in relation to the application of the AIFMD passport to non-EU AIFMs and AIFs
- Twelve countries reviewed
- Follows assessment of six countries in July 2015

AIFMD THIRD COUNTRY REVIEW

Jurisdiction	ESMA Review
Canada, Guernsey, Japan, Jersey, Switzerland	No significant obstacles impeding the application of the AIFMD passport to managers or AIFs
Hong Kong, Singapore	(AIFs only) No significant obstacles impeding the application of the AIFMD passport to AIFs
United States	No significant obstacles regarding investor protection and the monitoring of systemic risk criteria which would impede the application of the AIFMD passport, but with respect to the competition and market disruption criteria, ESMA considers there is no significant obstacle for funds marketed by managers to <u>professional investors</u> which do not involve any public offering
Australia	No significant obstacles regarding market disruption and obstacles to competition impeding the application of the AIFMD passport, <u>provided that</u> ASIC extends to <u>all</u> EU Member States the “class order relief” currently available only to some EU Member States, from some local regulatory requirements
Bermuda, Cayman Islands	No definitive advice with respect to the criteria on investor protection and effectiveness of enforcement (both countries are in the process of implementing new regulatory regimes and the assessment will need to take into account the final rules)
Isle of Man	Absence of an AIFMD-like regime makes it difficult to assess whether the investor protection criterion is met

The logo for K&L GATES, featuring the text in white on an orange rectangular background.

K&L GATES

A blurred background image showing a city skyline at night with illuminated buildings and lights.

2016 INVESTMENT MANAGEMENT CONFERENCE

Recent Developments in the Asset Management Industry: DOL Fiduciary Regulation

Robert L. Sichel, Partner, New York

TOPICS

- Common Misconceptions
- Background
- Selling/Promotional Activities



Common Misconceptions



COMMON MISCONCEPTIONS

- I'm already an ERISA fiduciary so the new regulation does not impact me
- I do not have to deal with ERISA because none of my funds are ERISA plan asset funds (e.g., ERISA investors are below 25%; mutual funds)
- My sales people do not provide investment advice



Background



HOW DOES ONE BECOME AN ERISA FIDUCIARY?

- ***Discretionary Fiduciaries:*** By exercising discretionary authority or discretionary control with respect to the management of an employee benefit plan covered by ERISA (e.g., 401(k) plans) or an IRA
- ***Investment Advice Fiduciaries:*** By rendering investment advice to such a plan for a fee or other compensation or having any responsibility to do so; regulations define the scope

NEW REGULATION

- In April 2016, the Department of Labor issued a new regulation that re-defines “investment advice fiduciary” and brings radical change to many aspects of the U.S. retirement industry
- The regulation greatly expands the group of market participants to be deemed ERISA fiduciaries and alters key “prohibited transaction” exemptions

UNDER THE NEW REGULATION

- Investment advice includes certain “recommendations”
- “Recommendations” broadly include statements that would reasonably be viewed as **suggestions** to take or refrain from taking a particular course of action (no mutuality requirement); for example, “you should invest in my fund” is a recommendation
- Content, context and presentation inform the determination
- The more individually tailored the communication, the more likely it is a recommendation
- Investment advice could include selling/promotional activity



Selling/Promotional Activities



TWO PHASES TO CONSIDER

Phase 1

Selling/Promotional

Hired

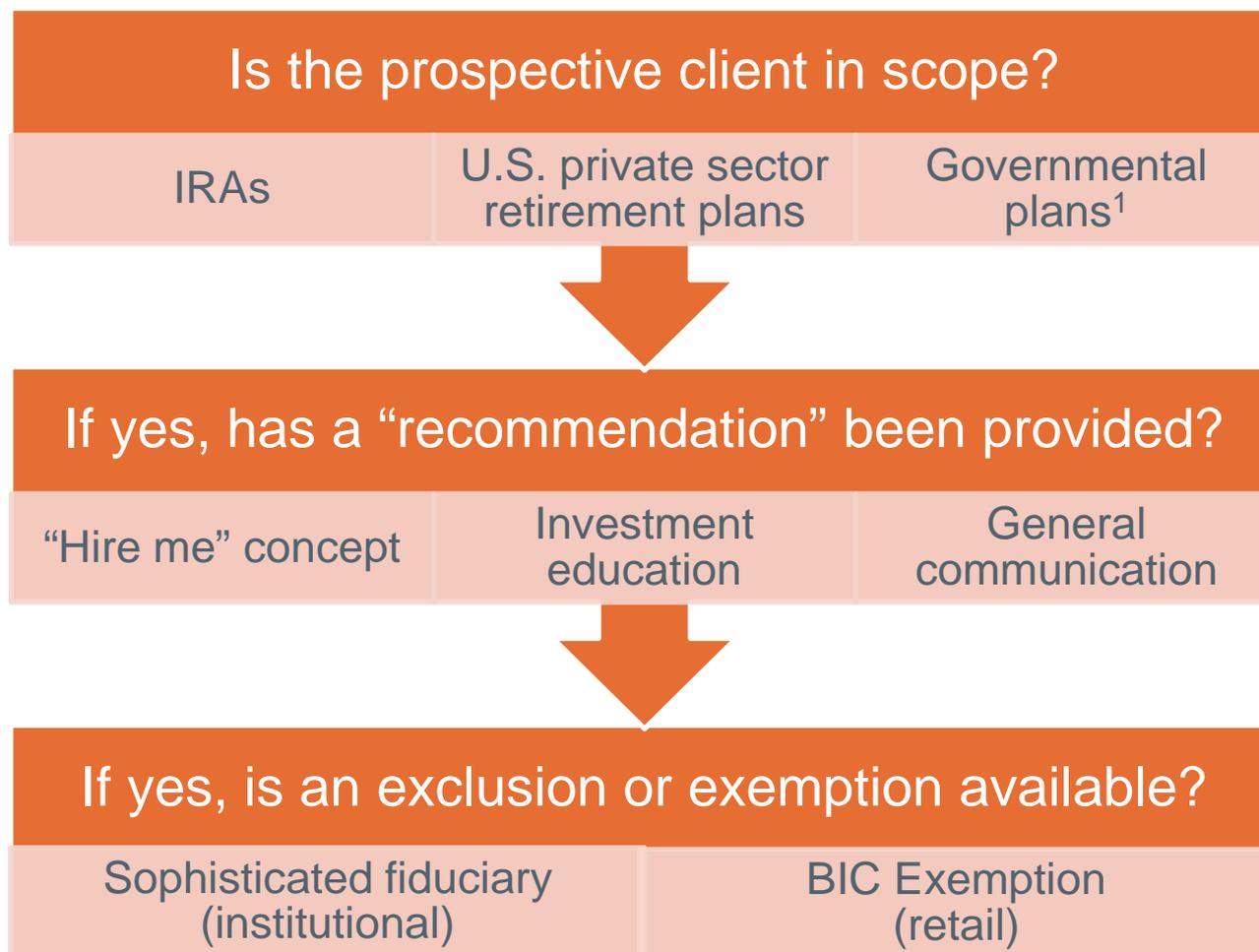
Phase 2

Providing Advice/
Exercising
Discretion

WHEN DOES FIDUCIARY STATUS ATTACH?

- Historically managers avoided ERISA fiduciary status when selling products and services (phase 1) by making sure there is no “mutual understanding” that the manager is providing investment advice
 - Disclaimers on marketing materials
 - Representations in subscription agreements and IMAs
- The new regulation may cause a manager to become an ERISA fiduciary during phase 1, even if the manager is selling a non-plan asset fund
- Adverse consequences were this to happen

ANALYSIS OVERVIEW



¹ Some governmental plans are subject to state and local laws that incorporate ERISA concepts or seek to be treated as ERISA investors contractually

ACTION STEPS

- Determine preferred approach or approaches
- Develop and implement a process to promote adherence
 - Sales training
 - Written procedures
 - Expanded compliance review of marketing materials and practices
 - Additional investor representations to fund documents and IMAs
 - Due diligence on the client's fiduciary

K&L GATES