

An Excerpt From:

# K&L Gates Global Government Solutions<sup>®</sup> 2012: Annual Outlook



### Changing Dynamics In U.S. Regulation of Investment Products

Regulatory risk, always a high priority in the heavily regulated investment management industry, is shifting in focus as U.S. regulators respond to increasing congressional and judicial demands. The industry's primary regulator, the Securities and Exchange Commission (SEC), is working hard to rebuild its reputation as a tough defender of consumer interests after suffering heavy criticism for failing to identify the Madoff Ponzi scheme and to regain ground from a long period of deregulation. The SEC is fighting an uphill battle on various fronts that affects how it approaches regulation going forward, including facing other players that now have a hand in affecting how the fund industry is regulated. Some of the dynamics in play are as follows:

#### *The Impact of Dodd-Frank on Regulatory Initiatives*

As the wide-ranging regulatory reform initiatives contained in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) begin to take shape, its potential to influence the regulatory process in less obvious ways is becoming more evident. To a far greater extent than when they were originally enacted in the 1930's, the federal securities laws now under the Dodd-Frank Act impose highly detailed regulatory requirements—details that previous legislators would have delegated to the

agency with substantive knowledge of the industry being regulated. Rather than setting basic policy standards and a framework to be interpreted and enforced by a sophisticated regulatory agency, Congress, under Dodd-Frank, set much of the SEC's regulatory agenda for a number of years and kept the agency on a short leash to report back regarding its progress in many areas.

Dodd-Frank's ambitious rulemaking agenda that Congress established for the SEC has strained already scarce SEC resources and impacted SEC priorities for its other rulemaking initiatives. By

tightly scheduling several years of rulemaking deadlines, Dodd-Frank may have inadvertently forced the SEC into the enforcement arena for carrying out its own agenda. Indeed, following its enactment, the director of the SEC's Division of Enforcement outlined a series of new initiatives including, among other things, the formation of a dedicated Asset Management Unit. This unit now consists of approximately 65 lawyers and other professionals, and has been aggressive in bringing enforcement cases against advisers, funds and their personnel.

The Division has aggressively focused on mutual fund fees, despite recent U.S. Supreme Court decisions that could scale back potential liability claims against investment advisers and fund boards regarding the level of fees charged. The Division recently fired its first shot across the bow of the industry as part of this initiative when the SEC issued a cease-and-desist order against an adviser for authorizing \$1.8 million of payments for more than ten years to a sub-adviser who allegedly did not provide the advice, research and assistance services as represented by the adviser to the fund and its board. All indications are that the Division intends to continue bringing additional fee cases, which the industry is carefully monitoring in an effort to identify the "metrics" the Division has said it is applying to identify industry outliers.

#### *Court Oversight of SEC Settlements*

The U.S. District Court for the Southern District of New York (SDNY) has recently criticized the SEC's long-standing practice of resolving enforcement actions through negotiated settlements in which defendants neither admit nor deny the allegations. In November 2011,

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Judge Rakoff of the SDNY refused to accept a \$285 million proposed SEC settlement with a bank over the sale of toxic mortgage securities on the grounds that the SEC's policy, "hallowed by history, but not by reason," deprives a reviewing court "of even the most minimal assurance that the substantial injunctive relief it is being asked to impose has any basis in fact." In his decision, Judge Rakoff particularly challenged the settlement for letting the bank off the hook on negligence charges only and without admitting anything, and what he characterized as a penalty that was nothing more than a "modest cost of doing business."

Clearly irritated by the decision, the director of the SEC's Division of Enforcement promptly issued a retort stating that "[w]e . . . believe that the complaint fully and accurately sets forth the facts that support our claims in this case as well as the basis for the

proposed settlement. These are not 'mere' allegations, but the reasoned conclusions of the federal agency responsible for the enforcement of the securities laws after a thorough and careful investigation of the facts." He also noted that the court's criticism, among other things, "ignores decades of established practice throughout federal agencies and decisions of the federal courts." Judge Rakoff had previously criticized another proposed SEC settlement related to bundling of toxic mortgages on similar grounds. It is possible that the SEC's ability to enter into such settlements will continue to be stymied in the SDNY and elsewhere, which could further tax the SEC's limited resources and frustrate its enforcement efforts.

### *Court Oversight of SEC Rulemakings*

The U.S. Court of Appeals for the District of Columbia Circuit (DC Circuit) has also dealt the SEC a series of blows in its rulemaking efforts, most recently this

past July when it struck down the SEC's recently adopted proxy access rule that required public companies, including mutual funds, to provide proxy disclosure and require shareholder vote related to shareholder-nominated candidates for the company's board of directors. The case was the third instance in recent memory that the DC Circuit criticized the SEC for "fail[ing] adequately to consider [a] rule's effect upon efficiency, competition, and capital formation." The DC Circuit, in a unanimous opinion, harshly chastised the SEC for having "inconsistently and opportunistically framed the costs and benefits of the rule; failed adequately to quantify the certain [sic] costs or to explain why those costs could not be quantified; neglected to support its predictive judgments; contradicted itself; and failed to respond to substantial problems raised by commenters." The DC Circuit also noted that the SEC's "decision to apply the rule to investment companies was also arbitrary" and its rationale in that context was "utterly mindless."

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The case reinforces the DC Circuit's increasing reluctance to defer to SEC process and fact-finding and represents a continuing shift in the balance of powers and allocation of authority to the SEC. Under classic New Deal principles of administrative agency autonomy and judicial deference, broad powers were delegated to agencies along with room for flexibility and expertise to deal with issues within their jurisdiction. Courts have been generally deferential to this approach under established legal concepts. To the extent the DC Circuit continues to override SEC judgments, however, many of the rulemaking initiatives on the SEC's agenda could be at risk. Particularly to the extent that new SEC rules threaten an established industry practice or result in increased costs, industry members may be encouraged to challenge them in court. Given the SEC's recent track record before the DC Circuit, proposed rules may well be sent back to the drawing board, and their implementation significantly delayed or indefinitely stalled.

### ***Financial Stability Oversight Council (FSOC) Oversight.***

The FSOC, created by Dodd-Frank, is not a government agency as such, but a framework for agency coordination and financial stability oversight. It includes among its 15 members, the chairs of the

major banking agencies, the SEC, the Commodity Futures Trading Commission, and representatives from state securities, banking and insurance regulators. Notably, a significant majority of the ten FSOC voting members consists of banking regulators. The historic dichotomy in the United States between banking regulation (which depends on secrecy to protect its primary concern for the safety and soundness of banking institutions) and securities regulation (which is primarily concerned with investor protection and capital formation through full and fair disclosure) suggests that the autonomy of the SEC, which represents only one vote on FSOC, and the principles it represents, might suffer over time.

One area in which SEC authority may be in the balance currently relates to money market fund regulation, clearly an SEC prerogative. FSOC's authority over so-called systemically important non-bank financial institutions (SIFIs) has caused FSOC to focus on money market funds' potential to impact the financial stability of the U.S. economy, and FSOC has been following carefully the SEC's progress on reform of the industry. In November 2011, the SEC chair gave a speech in which she referred to a statement in a recent FSOC Annual Report and noted that "the SEC—working with FSOC—is evaluating options to address the structural vulnerabilities posed

by money market funds." She further noted that "[t]hroughout the process of considering reform options, we have benefitted greatly from meaningful comment, critical thinking, and in-depth analysis from both regulators and public commenters," presumably referring to the regulators represented on FSOC. She concluded by stating that she "look[ed] forward to making substantial progress on our money market fund reform initiative in the coming months so that we can issue a proposal in very short order. We cannot let this issue linger." Some have suggested this indicates that the SEC is under pressure from within FSOC to effect reform of the money market fund industry; presumably the reform ultimately proposed by the SEC also will bear the imprint of FSOC influence.

### ***Conclusion***

Shifts away from traditional New Deal deference to regulatory agencies are changing the balance of power between the SEC and Congress, and between the SEC and the courts. Also, the newly created FSOC has taken an active role in asserting its authority in certain areas previously uniquely within the SEC's jurisdiction. These and other dynamics will have an impact on the ability of the SEC to effectively protect consumer interests and will influence the relationship between the SEC and the investment management industry it regulates, all in ways that are yet to be seen.

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