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ACA Insight

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"Advisory firms may find it more costly to comply with the principles-based requirements of some of the new rules that contemplate the development of non-standard procedures."

2020: New Rule Consequences, Election Fallout, Enforcement and More

Every year brings new developments and challenges, but as far as investment advisers and funds go, 2020 may pack quite a wallop. Aside from adoption of a final Advertising Rule, Proxy Advisory Firm Rule and others, expect the SEC to move forward with proposing a revamped Custody Rule and possibly more self-reporting initiatives along the model of the concluded Share Class Disclosure Initiative. As if that isn't enough, fund managers will need to ensure their funds comply with the requirements of the recently adopted ETF and Liquidity Risk Management Rules.

Let's also not forget that 2020 is an election year. Should President **Donald Trump**

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How Much is Enough? Peirce Questions SEC Data Collection and Use

As the SEC increasingly hones its ability to gather data and finds new ways to analyze it, Commissioner **Hester Peirce**, in a recent speech, waved a yellow caution flag. She challenged not only the amount of data the agency collects, but what the SEC's attorneys and economists do with it.

The questions she raised in her address before the **National Economists Club** in Washington DC dealt with three themes:

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Associations and Firms Protest Deduction Limitation in Trump Tax Cut

The **Investment Adviser Association** and a group of seven other associations and firms, in a recent letter to Congressional leaders, criticized a portion of the 2017 Tax Cuts and Jobs Act – better known as President **Donald Trump's** tax cut – that limits their ability to take part in a 20 percent tax deduction.

"We believe it is sound policy to allow these hard-working business owners to fully benefit from this new deduction in whole," they wrote to the chairmen and ranking members of the Senate Finance Committee and the House Ways and Means Committee. "We urge Congress to resolve via clarifying legislation that financial

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win re-election, the SEC under Chairman **Jay Clayton** is likely to continue on its current course. Should another candidate win November's election, it may be that the final two months of 2020 will preview some changes to take place in 2021.

Mayer Brown partner **Stephanie Monaco** wondered whether a change in federal administration would bring with it "a complete reversal of Clayton-led initiatives. It is extraordinarily difficult and extremely costly for the population of registrants to pivot one way and then reverse course, as occurred with the adoption and then demise of the Department of Labor's Fiduciary Rule when the Trump Administration took over from the Obama Administration."

The election year itself may have an effect on the SEC's progress, said **Willkie Farr** partner and former SEC Deputy Chief of Staff **James Burns**. "Election years are notoriously difficult times for the agency to accomplish anything in its rulemaking agenda, so it will be interesting to see whether the agency makes strides on the Derivatives Rule or other priorities."

Most new years see continuations, in one way or another, of developments begun in the previous year. They also see the start of new developments that may be completed in the same year, or that may presage resolution in subsequent years, in this case, 2021 or later.

Much will depend on the economy, currently measured by many as being in the 10th year of a recovery, which, unless the business cycle has been revoked, cannot continue forever. "We're likely heading into a more challenging environment," said **Friedman Kaplan** partner **Anne Beaumont**. "It's easy to be a successful manager in a good market, but when the market turns, some firms will run into trouble or go out of business – and when the tide goes out, there's often some funny-looking stuff on the bottom."

Rulemaking and unintended consequences

Former SEC Director of Investment Management Director **Barry Barbash**, now with Willkie Farr, suggested that a number of the agency's recent rules, both those adopted and those proposed, "will result in significant operational changes in how advisers communicate with their clients."

For instance, he said, the proposed Advertising Rule revision distinguishes in some contexts between retail clients and non-retail clients. "This distinction could result in the need for an adviser to use multiple versions of communications with its clients. Consider a case in which two funds advised by the same adviser – one fund having retail clients and the other having non-retail clients – invest in the same securities in tandem. The new Rule, if adopted with the same provisions as in the proposed version, could effectively require the adviser to the two funds to use different sets of advertising materials – one for the retail fund and another for the non-retail fund – to describe the same portfolio holdings."

"It is extraordinarily difficult and extremely costly for the population of registrants to pivot one way and then reverse course."

"Advisory firms may find it more costly to comply with the principles-based requirements of some of the new rules that contemplate the development of non-standard procedures. Developing those kinds of procedures at least initially could be more costly for advisers, particularly small- and medium-sized companies, and in general present a higher barrier of entry into the advisory business," Barbash also said.

Barbash noted that the new regulations did not seem to him to be deregulatory in nature. "I see the new rules as more re-regulatory than deregulatory," he said.

"Chief compliance officers in shops that offer ETFs or want to offer ETFs will be busy," said **Morgan Lewis** partner **John McGuire**. "Not only do you have the ETF Rule itself, which will require some new procedures, but many shops will be looking at semi-transparent ETFs, to which the SEC recently gave a green light, which will have a different set of compliance policies. I also expect that many CCOs are still finalizing, or still tinkering with, their liquidity risk management programs."

Akerman partner **Paul Foley**, looking at the agency's proposed changes to the "accredited investor" definition (*ACA Insight*, 12/23/19), suggested that, if adopted along the same lines as proposed, a new Rule "will put pressure on advisers from clients to invest their money into private investments, which may lead to more litigation down the line due to the increased risk of these investments. The change could be a source of additional revenue or it could be a liability."

"Advisers will need to make sure that they perform the necessary due diligence required by these investments" in order to mitigate this risk, he said, "or just learn to say 'no' to clients. This will depend, of course, on the advisers involved and their confidence level in the private investments."

"I see the new rules as more re-regulatory than deregulatory."

The Custody Rule

As for specific rules that may see action in the new year, one likely to be reformed is the Custody Rule – and now that the SEC has proposed a reformed Advertising Rule, which many in the industry thought was overdue, Custody Rule reform may seem more likely. No more authoritative source than the SEC itself has said it will look at a revamped Custody Rule in 2020. In its Spring 2019 Regulatory Agenda, it moved reform of the Rule to its short-term listing, meaning that the agency would take action on it within the following 12 months. It was still there when the SEC's fall agenda – the agenda is updated every six months – was published by the federal Office of Management and Budget.

The listing states that the agency's Division of Investment Management "is considering recommending that the Commission propose amendments to existing rules/and or propose new rules under the Investment Advisers Act to improve and modernize the regulations around the custody of funds or investments of clients by investment advisers."

The existing Rule has been much criticized by advisers, funds and their legal counsel for years because of its complexity, a required surprise examination, and for a seemingly growing list of types of custody. What many appear to want are a simple definition of custody and clear compliance requirements.

"Amendment of the Custody Rule for investment advisers is an area that many believe is overdue for greater regulatory clarity and simplification," said **Sidley Austin** senior counsel **Jonathan Miller**. The **Investment Adviser Association**, in a December 2018 letter to the Commission, called on the SEC to take a number of steps to reform the Rule, including limiting it to risks presented by actual physical custody (*ACA Insight*, 1/14/19).

Pickard Djinis and Pisarri partner **Mari-Anne Pisarri** said that much of the problem with the Rule could be resolved simply by eliminating the surprise examination requirement. "That would leave the central protections of the Rule intact, but spare the industry and staff the inordinate time they spend trying to thread the needle on what does and does not constitute custody," she said.

However, warned **Sidley Austin** partner **Laurin Blumenthal Kleiman**, reform of the Custody Rule "could be a 'be careful what you wish for' situation. The Rule is clearly out-of-date and unworkable with respect to the universe of 21st century advisory services and products. In its attempt to update the Rule, however, the SEC staff has a significant challenge to both respect the Rule's underlying goal of safekeeping assets under management while understanding the realities surrounding both traditional securities and non-traditional assets like loans, swaps and real estate-related securities."

Enforcement and examinations

"The tenures of most recent SEC chairs have finished on the examination and enforcement fronts with a bang, not a whimper," said Burns. "Given the regular cycle and large number of open examinations of advisers we know about, I'd expect a significant harvest of settlements by the end of the summer."

"If the executive branch changes, will we go back to the days of 'broken windows'?" asked Monaco, referring to the enforcement philosophy of the SEC prior to Clayton, when the Division of Enforcement pursued violations both small and large. The belief, which then-Chair **Mary Jo White**, a former U.S. attorney for the Southern District of New York, brought with her when she joined the agency, was that prosecuting small violations deter large ones.

In a recent speech, Division of Enforcement Co-Director **Stephanie Avakian** lauded the success of the Division's Share Class Disclosure Initiative, which saw approximately 95 advisers settle with the agency after taking advantage of the Initiative's offer to self-report in exchange for, in most cases, not being charged civil money penalties. She also used the opportunity to let the industry know that the Division will consider using the same formula in other areas.

"This situation is not unique," Avakian said, referring to the Share Class Disclosure Initiative. "The same principles and disclosure obligations can apply in other circumstances. Because of that, we are not resting on the success of the Share Class Initiative. Let me assure you, we are looking for other undisclosed material conflicts – and we are finding them."

Eversheds Sutherland partner **Brian Rubin** said that there may be action regarding share classes and other conflicts, as well. "The SEC's Share Class Disclosure Initiative and FINRA's 529 plan show the regulators' focus on share classes and conflicts," he said. "I think those actions were just the beginning."

"More recently," he continued, "we've seen the SEC begin investigations regarding conflicts related to cash sweep accounts. Firms may want to focus on share classes and conflicts before the SEC and FINRA begin their next official or unofficial initiatives and sweeps."

Digital assets, LIBOR and more

Rulemaking, enforcement and examinations are far from the only areas expected to be touched by 2020, however.

"It's now several years into the rise of bitcoin and other digital assets, and the infrastructure around them continues to become institutionalized – digital asset custodians, digital asset brokers and exchanges, digital asset fund managers," said **Shearman & Sterling** partner **Nathan Greene**. "What we still don't have is helpful SEC staff guidance to supersede the largely inconclusive Division of Investment Management letter from January 2018."

"Technological change is a super trend," he said. "Every aspect of the investment management business, compliance included, has been automated to some degree, and the combination of algorithms, data and ever falling costs of computing power will continue its creeping remake of the industry."

Then there is the ongoing transition of the financial community away from using the London Interbank Offered Rate (LIBOR) as a benchmark.

Beaumont said that she expects some 2020 movement as market participants accelerate their work to transition from LIBOR. She noted the SEC's July 2019 statement in which the agency urged all market participants using LIBOR to begin the process of moving away (*ACA Insight*, 7/22/19).

"More is likely to come from the SEC, possibly an exam sweep," she said. "The agency moved the LIBOR transition front and center with its statement, so even though LIBOR's not going away until the end of 2021, there will be movement."

Finally, there is the role that environmental, social and governance (ESG) investing will play next year and in future years.

SEC Commissioner **Hester Peirce**, in a June 2018 speech, compared the use of ESG factors in assessing firms to the threat of receiving a scarlet letter (*ACA Insight*, 7/29/19), but not all agree. "The ESG train is rolling hard and fast now, with many more fund managers talking and thinking about the role ESG plays in their investment processes," said Greene. "This will only accelerate in 2020 and will continue to be led by trends from Europe."

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How Much is Enough?

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- How much data is enough?
- Whether there are ways that the SEC can look to academics and market participants to assist us in regulating markets; and
- The role that economists can play when it comes to explaining the agency's role on questions of sustainable morality.

"The temptation to collect more data only grows with the sophistication of our analytical techniques and tools."

Paul Hastings partner **John Nowak**, in commenting on the speech, said that "we live in a world where data is king, but that does not mean that the SEC should have access to it all. Commissioner Pierce's speech raises some valid concerns about the agency's commitment to gather and analyze increasing amounts of data. Before the SEC requests access to petabytes of additional data, it must first consider the personal privacy issues associated with the data, the cost of collecting and hosting the data, and the usefulness of the data to the SEC's overall mission."

"One of the frequent critiques of the SEC is that they don't understand the markets they are regulating and in particular, the markets in which they are bringing enforcement actions," said **Friedman Kaplan** partner **Anne Beaumont**. "If we want them to have deep knowledge of the markets, they need information about them, but there's a difference between information – meaningful, actionable information – and data."

Peirce, one of the five-member Commission's more conservative members – aside from the chairman, two are nominated by Democrats and two by Republicans – raised the following topics.

Data quantity

"One thing I have noticed about the economists with whom I work at the SEC is that they love data," Peirce said, adding that she recognizes the information can be used "to fight fraudsters, determine where a regulatory threshold should be set, or asses the effect of a regulatory obligation."

Aside from economists, she said that the agency's regulatory lawyers and examiners "like it too because it can give them a better handle on the industry they oversee."

While "the temptation to collect more data only grows with the sophistication of our analytical techniques and tools," she said, collecting data "is not free – not for us, not for the industry from which we collect it, and not for investors. Registrants that provide the data often incur very large direct costs to produce the data in the timeframe and at the frequency we require."

More specifically, Peirce looked at SEC data collection in terms of Form PF, which is used to gather information from private funds, and the Consolidated Audit Trail (CAT), an ongoing agency product that, when completed, is expected to allow the agency to track transactions on public exchange from inception to completion. Here's what she had to say about each:

- **Form PF**. Noting that this is the form used to collect information on the private funds, she said that this data "are commercially sensitive, so concerns about the security of the data are real." The form also takes a long time to complete, and "there is also a question about how useful the data we collect on Form PF actually are to the SEC. Because filling out the form requires each firm doing the reporting to make judgment calls about what data are responsive to each field, data collected from one fund may not actually correspond to the data collected from other funds, which makes it difficult (or misleading) to conduct cross-industry analyses of the data." Further, she said, there are also inconsistencies between what the funds supply to the SEC and what they provide to the CFTC. "It is also unclear whether the data are fit for purpose," Peirce said. "Form PF is supposed to focus on the risk a fund poses to the financial system, but it collects a lot of data points that lack any real nexus to systemic stability."
- **The CAT**. This program, once up and operating, will

contain all transactions in both the equities and options markets. "As you can imagine, regulators and enforcement staff love such a rich reservoir, but it is not cheap – the exchanges and brokers have already incurred huge expenses to get the CAT almost ready to launch and will continue to incur costs throughout the CAT's life. If cyberthieves break in, there will be additional costs to the investors whose data are compromised; and, not least, there is the cost of eroded liberty, as the government monitors Americans' financial transactions."

Third parties

Peirce's second question was, "Given that better data are easier to come by, are there ways that we can look to academics and market participants to assist us in regulating markets?" If market participants had access to this data, they would be able to make better decisions, she said. "Even for some functions that are often found in regulatory hands, outside help can be beneficial."

Noting that she has been a critic of post-financial crisis regulation that looks to regulators alone to identify and solve problems, Pierce suggested that "lots of people working independently are better at identifying problems and generating solutions than a small group of regulators holed up in musty regulatory agencies in Washington, DC." What lawyers and economists working in such regulatory agencies need to ask themselves, she said, is how they can enlist the help of such people?

Sustainable morality

Here, in relation to her third question, Peirce veered a bit away from the collection and use of data, and delved into the role that regulators should play in what she terms "sustainable morality."

"The motivating force behind this trend seems to be that finance has been too focused on raw dollars, and insufficiently focused on building a financial system that fosters a better, more sustainable society," she said. "Regulators are thinking about how they can force financial firms to take into account environmental and social considerations as they allocate capital." In other words, Peirce was addressing the ESG movement.

"I disagree that such an economy will result from regulators taking on the role of steward of morality," she said. "In fact, I think the opposite is true."

Sustainable morality, Peirce said, "is not morality dictated by a few powerful financial regulators, but morality that reflects the decisions and preferences of individuals throughout society. Free markets give expression to those decisions and preferences."

The question that really needs to be answered, she said, is "How can economists . . . do a better job of explaining the role that a free economy can play in improving people's lives, particularly the people who face the greatest deprivation and despair? In short, how can we best explain that sustainable morality does not require more government control of economic decision-making, but less?"

Associations and Firms

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services professionals such as broker-dealers, financial planners and investment advisers shall qualify as 'qualified trades or businesses' and should not be considered 'specified services trades or businesses' under new Internal Revenue Code §199A."

In addition to the IAA, which represents investment advisers, the letter is signed by the **Financial Planning Association**, which represents financial planners; the **Financial Services Institute**, which represents independent financial services firms and independent financial advisers; and the **National Association of Personal Financial Advisors**, which represents fee-only financial advisers; as well as firms **Cetera Financial Group**, **Commonwealth Financial Network**, **LPL Financial**, and **Raymond James**.

"It is rare that such a diverse group of organizations are all in unity on a legislative or regulatory request," said **Stark & Stark** partner **Max Schatzow**. "However, this is a straightforward request to benefit almost the entire industry. All persons involved in specified trades or businesses making above $315,000 for a married couple filing jointly or $157,500 otherwise are currently ineligible or do not receive the full benefit of the deduction. Given the income levels of most in the investment profession, it is clear to see why this is an issue."

"The IAA believes that all financial services professionals should benefit from the 20 percent pass-through deduction – not just some of them," said IAA Vice President for Government Relations **Neil Simon** in a separate statement. "It's puzzling that insurance brokers and real estate brokers can take full advantage of this new deduction, while investment advisers, financial planners and other financial advisors are excluded. Depriving them of this deduction unfairly puts them at a disadvantage, making it harder for them to invest in their businesses, their employees and their clients."

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"For reasons that are not readily apparent, Congress excluded financial advisers, financial planners and investment advisers from the 20 percent tax deduction for income from pass-through businesses that were a major feature of the 2017 Tax Cuts and Jobs Act," said **Shearman & Sterling** partner **Jay Baris**. "Understandably, certain investment adviser trade groups objected, claiming that the exclusion unfairly disadvantages this class of service providers. Was this omission an unintentional oversight, as the industry groups suggest, or a conscious decision by Congress to exclude financial advisers? The answer would determine whether Congress is inclined to change the law."

The deductions

At issue in §199A is a 20 percent deduction for qualified business income for owners or shareholders of pass-through businesses, such as S corporations, partnerships and sole proprietorships, according to the letter. "Owners and shareholders of certain types of businesses – the 'specified service trades or businesses' – are limited in their ability to apply the 20 percent deduction if their overall taxable income exceeds certain thresholds. Unfortunately, financial advisers, financial planners and investment advisers currently fall under this definition."

Under §199A of the law, those filing their taxes jointly as married couples can claim the 20 percent deduction if they make less than $315,000 in taxable income, but the deduction will be phased out for specified services and a limitation phased in for non-services if they earn between $315,000 and $415,000 in taxable income. For those married couples filing jointly that earn more than $415,000 in taxable income, there is no deduction for specified services, and wage and cap testing for non-services.

Individuals filing as single taxpayers can claim a 20 percent deduction if they make less than $157,000 in taxable income, but face a phased-out deduction for specified services, as well as a phased-in limitation for non-services if they make between $157,500 and $207,500 in taxable income. Individuals filing as single taxpayers who earn more than $207,500 in taxable income receive no deduction for specified services, and wage and cap testing for non-services.

Discrimination alleged

"Right now, real estate brokers and insurance brokers are able to enjoy the benefit of the 20 percent pass-through deduction," the letter states. "While we recognize that financial advisers, financial planners and investment advisers are regulated differently than real estate and insurance, as small business owners, they face the same burdens and challenges. Congress should not pick winners and losers."

The letter signatories argued that "the current statutory language unfairly and unintentionally disadvantages financial advisers, financial planners and investment advisers and diminishes their ability to invest in and build their businesses. They employ thousands of individuals across the United States and are community leaders, supporting millions of clients. They also provide assistance on a wide range of issues, dealing with challenges such as how to create a savings plan, and how to plan for family transitions."

Finally, the letter notes the role that financial advisers, financial planners and investment advisers play in being "drivers of the economy," as well as "a vital solution to the retirement savings crisis that America is facing."

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