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"Fees based on AUM, while they are easy to calculate and collect, will become increasingly difficult to justify, with increased automation of portfolio management, as anything but a nominal service charge."

Advisory Firm Fees: What the Future May Hold

The world of advisory firm compensation is changing and will continue to change. The next five to 10 years may see discounts, alternative forms of compensation, clients making investments that do not involve fees at all, and more. Advisers that want to stay ahead of the curve will keep up to date and be prepared for any likely eventuality.

"I expect the evolution of advisory fee structures to continue in the future," said **Paul Hastings** partner **John Nowak**. "Tax changes, regulatory scrutiny and competitive pressure in the marketplace will cause advisers to offer more creative alternatives to the traditional assets under management fee model – and I expect those alternatives

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Assess LIBOR Exposure in Preparation for Shift

Advisory firms need to prepare for the financial community's coming switch from the London Interbank Offered Rate (LIBOR) as the most commonly used interest rate benchmarks. Those who think of the benchmark situation as a problem affecting primarily banks are likely to be in for a rude shock, as many portfolios and financial contracts may be affected by it.

Historically, LIBOR is the benchmark based on the interest rate that major banks charge each other to borrow money. It is used for a wide variety of transactions and can be found laced through many of the positions that advisory firms manage in their portfolios.

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Court Decision Removes Threat to SEC Pursuit of Cryptocurrencies

A federal district court judge has reconsidered a previous ruling and granted a preliminary injunction against a digital token company. In doing so, he also removed a potential threat to a key SEC tactic in the agency's enforcement actions against cryptocurrency operators.

In his February 14 order granting the agency's motion for a partial reconsideration of a November ruling, Judge **Gonzalo Curiel** of the U.S. District Court for the Southern District of California said that the SEC had met the test of proving that the tokens involved in the case were "securities." The agency sought the ruling as part of its

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Advisory Firm Fees

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will run the gamut. Some fund advisers might simply provide fee discounts through side letters, while others might truly offer non-AUM based structures."

One thing is clear: The pressure that advisers are feeling on their fees is downward. Clients will expect better quality from their advisers and expect to pay less for it.

Willkie Farr partner and former SEC Deputy Chief of Staff **James Burns** attributes the downward pressure to two main factors:

- **Low cost advice through technology.** "Increasingly, instead of the traditional approach to personalized, individualized advice where a client might visit his investment adviser representative at his office, they go out for drinks, swap stories, discuss the market, maybe take in some kind of social activity, and then discuss investment recommendations, today a client is just as likely to interact through automated processes. So the question arises, what becomes the basis for charging the advisory fee?" Information, he said, "is now sliced and diced with the aid of algorithms." Robo-advisers "are just the edge of the wedge. Firms are deploying electronic tools that provide specifically tailored investment and financial advice to clients, such as how much their individual Social Security, insurance or retirement benefit projects will affect how they should invest – tools that increasingly require less human intervention."
- **SEC actions.** Advisory firms are likely to continue to become increasingly sophisticated in their approaches and competitive with one another as the SEC continues scrutinizing fees, asking advisers just what they are charging their clients for, whether the fee is fair, and whether associated disclosures and adherence to rules around advertising, among other things, are in good order, Burns said. Even as all these developments evolve, firms will continue to have to be vigilant that the advice they provide and the ways they deploy their services don't run afoul of other regulatory considerations, such as the agency's periodic concern about whether certain advisers may be operating what amounts to an unregistered investment company, said Burns. "This evolution will also raise compensation questions. Both of these developments will create increased competition for better sophistication, efficiency and quality of service among advisers, something that will only add to the downward pressure."

Stern Tannenbaum partner **Aegis Frumento** believes that fees will be affected in future years by "a lesser need for portfolio design and monitoring. That is likely to be automated. However, I see a greater need for professional counseling about personal and financial goals. There are already practitioners who are certified public accountants, certified financial planners and attorneys, and who provide a holistic service to clients, advising them on their legal, financial and lifestyle options."

"That need will always be there, and probably in greater demand," he said. "That suggests that fees based on AUM, while they are easy to calculate and collect, will become increasingly difficult to justify, with increased automation of portfolio management, as anything but a nominal service charge. But professional counseling will always command premiums. I would not be surprised to see the more successful advisers moving away from AUM pricing and more towards a fee for service model."

Private fund considerations

Managers of private funds, of course, have different fee arrangements with their clients than do traditional investment advisers, who might invest predominantly in mutual funds and individual stocks and bonds. Traditional advisers typically charge only a management fee, while hedge fund managers, for instance, often charge a combination of a management fee, say 2 percent, and a larger-percentage performance fee of perhaps 20 percent.

Private fund managers may feel the downward pressure, just as traditional advisers do, said Nowak. Some alternative fee structures already used by hedge fund managers include the placement of a dollar cap on AUM-based management fees, phasing out management fees over time, waiving management fees altogether,

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or charging a fee that is tied to the level of liquidity.

"These alternatives are not new, but I imagine that we might see more of them in the future," he said.

The role of ETFs

Index-based exchange-traded funds now allow retail investors to invest directly in an index without going through an adviser. Some of these products carry no fees, said **Mayer Brown** partner **Stephanie Monaco**. "No-load ETFs appear to be the coming thing. Products are appearing in the marketplace that allow consumers to track the market without fees. So, advisers may increasingly have to contend with a reality that if they want to get paid, they had better out-perform the market."

After all, she said, advisory firm fees, including the basic AUM management fee, "are based on providing performance results that beat the market, beat the passive index ETF product. I wonder if the consuming public is going to keep paying if they do not get a better return than the market."

Performance fees, of course, are a separate question. Private fund advisers may charge clients both a management fee and a significant performance fee, and while the percentage of the performance fee may rise or fall based on market conditions, it is unlikely to go away, if only because the adviser earns it only when the investment meets certain performance standards. "If advisers wanted to charge performance fees more routinely, the Commission would have to petition Congress to change the Advisers Act," Monaco said, while adding that she "highly doubts" this will occur. "If it did, advisers would get performance fees when they beat the market and would not get them when they did not – putting more skin in the game."

Expenses

Soft dollar costs in the future are likely to be handled the way they currently are in Europe, where the **European Union's** Markets in Financial Instruments Director (MiFID II) requires them to be unbundled from commissions. MiFID II generally requires that advisers separate brokerage and execution costs. This means that advisers must pay broker-dealers for research in hard dollars from their own resources, or from special compliant research accounts, rather than paying soft dollars that are part of brokerage commissions.

"MiFID is having an impact here," Monaco said. "MiFID II has put a shot in the heart of soft dollar practices and paying up to brokers. It would seem that more and more, advisers will have to buy their own research, particularly when they have European and US clients."

That said, the SEC has provided advisers with a 30-month reprieve on this requirement, which should help ease the transition. Basically, the agency's Division of Investment Management, in an October 2018 no-action letter, said that it would "allow money managers to operate within the [soft dollar] safe harbor if the money manager makes payments for research to an executing broker-dealer out of client assets alongside payments for execution through the use of a research payment account (RPA) that conforms to the requirements for RPAs in MiFID II."

Assess LIBOR Exposure

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"It's everywhere," said **Friedman Kaplan** partner **Anne Beaumont**. "It's in securitizations, it's in derivatives contracts, it's in residential mortgages. Portfolios are infested with LIBOR."

"Large numbers of contracts and even technological processes will be affected, so that when you disrupt LIBOR, it affects everything," said **Perkins Coie** partner **Andrew Cross**. "Many of the transactions that funds and investment advisory clients enter into reference LIBOR," said. "It's built into anything that involves a financing charge, such as derivatives contracts and loan agreements."

Just when the switch from LIBOR will occur is not clear, nor are the new benchmark(s) that will replace it. The United Kingdom's Financial Conduct Authority stated in July 2017 that, as of the end of 2021, it will no longer compel banks to submit to LIBOR. While there has been a lot of regulatory activity around what will replace it, the market activity has been thin at best, and many open questions remain about how a replacement will be incorporated and how the act of replacement will affect market participants, Beaumont said.

In the meantime, advisory firms, as well as other financial institutions, would be wise to assess their LIBOR exposures and risk, stay on top of developments in this area, and engage with counterparts affected (*see below*).

Why the switch

LIBOR is phasing out for a number of reasons, some having to do with market forces, others with alleged manipulation. In the years leading up to the 2008 financial crisis, said Beaumont, some banks on the panel that sets LIBOR submitted what were considered "inappropriately low" interest rates, so as not to suggest that they were in trouble (submissions representing higher borrowing costs might have given the impression that those banks were having some difficulty). Others did so to allegedly advantage their trading positions.

Separate from such manipulation issues, LIBOR was becoming, for lack of a better phrase, out of step with the times. Three-month LIBOR is the most popular benchmark, but "banks no longer borrow for three months, having been forced to use longer-term borrowing for regulatory reasons," Beaumont said. With that increasingly being the case, the LIBOR panel now has very few real transactions to support their submissions.

When will LIBOR no longer be used? It's safe to say, at this point, that it will be in effect at least through the end of 2021, the date at which the FCA has said it will no longer require its use, said Cross. "It will probably take longer, as it is unlikely that LIBOR will go away by then. It will take a great deal of effort to switch to something else. People have legacy systems and LIBOR is built into those systems."

The prognosis

Ultimately, however, given the apparent growing mismatch between LIBOR and how banks today work, something will have to change, he said. "At some point, advisory firms and other financial institutions are going to have to make a decision as to whether they want to renegotiate their agreements on a bilateral basis with each respective counterpart or jump into some new industry standard protocol."

Just what the new industry standard will be, whether there will be more than one replacement, and just when lenders will find themselves required to use a new benchmark remain open questions.

The **International Swaps and Derivatives Association** (ISDA) has created a fallback benchmark protocol that can be used, which can be found on its website. Although, Cross said, it was designed with the European regulatory system in mind and has not been tested in the United States.

The Federal Reserve has also played a role, through its creation of the Alternative Reference Rates Committee (ARRC), which was formed to develop an alternative rate to LIBOR. ARRC announced in June 2017 that the recommended replacement for LIBOR in the United States would be a new benchmark called the Secured Overnight Financing Rate (SOFR), a broad, transaction-based measure of the cost of borrowing cash overnight collateralized by U.S. Treasury securities. However, whether that will be the final word on the matter is by no means certain.

"It appears that the adoption of SOFR will be on a voluntary basis, leaving considerable uncertainty, at this time, as to whether, when or how it will be implemented by various market participants," said **Sidley Austin** senior counsel **Jonathan Miller**. SOFR is a near risk-free, secured overnight rate, while LIBOR is an unsecured rate with credit and term components. It appears that much work remains to be done to develop SOFR as a viable alternative to U.S. dollar LIBOR.

"On occasion, SOFR had an increased level of volatility associated with it," said Cross, who said that while it might become the permanent LIBOR replacement, there were other possibilities as well. In addition to SOFR, these include:

- **Continuing with LIBOR.** Termed by some as "zombie LIBOR," this would be a version of LIBOR that uses the existing LIBOR framework but is not based on actual market transactions, said Beaumont.

- **A new benchmark.** The Federal Reserve Bank of New York has put its support behind SOFR, but there are other options, including the recently proposed Intercontinental Exchange (ICE) Bank Yield Index and lesser-known benchmarks like AMERIBOR. There is a regulatory consensus that any replacement for LIBOR should be transaction-based and not susceptible to manipulation, Beaumont said.
- **Multiple benchmarks.** Under this possibility, different asset classes might each use a benchmark that best applies to their respective circumstances.
- **Same benchmarks, different spreads.** Here there would be one benchmark, such as LIBOR, SOFR or something else, but with different spreads representing the costs to different markets. Cross explained that while it is common for different markets and products to have different spreads, the potential use of different underlying benchmarks will provide for an additional dimension and factor that investment managers will need to take into consideration, especially during the initial transition period away from LIBOR-only based pricing and valuation.

What advisers should do now

While a resolution to the current situation is not yet here, there are steps that advisory firms should take now. These include:

- **Find all your LIBOR.** The benchmark is so prevalent, said Beaumont, that it is "like the Y2K bug," when there was concern, just before the year 2000, that the coming millennium would cause various computerized processes and products to stop working, or work improperly. "People worried about whether everything from mainframe computers to microwave ovens would work. LIBOR is the same way – it's in places where you don't expect to find it." She suggested that advisers look at anything, both in terms of portfolios and in terms of a firm's operations, with life after 2021. On the portfolio side, Beaumont said, advisers may need to "drill down a few levels." The easy find for benchmarks will be in searching for provisions for interest rates in basic single-level loan documents, while more difficult would be collateralized debt obligations in which LIBOR might be embedded at multiple levels. As for the operational side, advisers should scrutinize their firm's existing borrowings and lines of credit. "Once you find them," she said of contracts that involve LIBOR, "look for their fallback provisions," referring to contractual provisions that describe what happens should there be a LIBOR disruption. "The catch, however, is that most of these fallbacks were not designed for a permanent cessation of LIBOR, but only for temporary interruptions. Unless amended, many of them will convert floating-rate instruments into fixed-rate instruments, which is likely to advantage one party economically."
- **Learn the landscape.** "Advisers should make themselves familiar with whatever potential replacements there are," said Cross. "Stay on top of how SOFR is interacting with other financial instruments. Go to the ISDA website and become familiar with published supplements." Beaumont suggested that advisers stay up to date with the information not only on the ISDA site, but also on the ARRC site and the ICE site. Miller suggested advisers review the LIBOR fallback provisions in their swaps and other derivatives documentation, as well as in the terms of other instruments with LIBOR exposure (for example, floating rate loans, bonds, notes and securitizations), to see whether or how the discontinuation of LIBOR is addressed. "Where a swap or derivative is being used to hedge exposure to LIBOR under another financial instrument, the adviser needs to evaluate the risk of a mismatch between the fallback provision in the derivative and the hedged instrument,"he said.
- **Engage with counterparties.** For transactions that extend beyond the end of 2021, advisers may want to consider reaching out to counterparties to make contractual amendments to manage the LIBOR transition risk in an orderly and uniform manner to the extent practicable, Miller said. Beaumont suggested that it's best for an adviser to get on the same page as soon as possible with those it does business with. "This includes pretty much everyone with whom the firm does business. A lot of change likely will be done with consensual amendments to contracts, which will be labor-intensive."

Court Decision

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original October 3 complaint to the court seeking to stop the San Diego-based digital company, **Blockvest**, and its founder, **Reginald Buddy Ringgold**, from moving forward with the sale of digital tokens.

A key tactic used by the SEC in its pursuit of digital companies that undertake initial coin offerings (ICOs) is that if those tokens are securities, then the company offering them must register them as such with the agency. Blockvest did not register its ICO with the SEC, even though it claimed that it had done so, the agency said in its complaint, which also alleged that Ringgold had created "a fictitious regulatory agency, the 'Blockchange Exchange Commission,'" along with a fictitious government seal, logo and mission statement, which the SEC said bore similarities to the agency's own.

When Judge Curiel denied the agency's request for a preliminary injunction, he did so stating that the agency and the defendants had presented the court with "starkly different facts" and that, because of the disputed facts, "the court cannot make a determination whether the test . . . tokens were 'securities.'"

The judge's reconsideration of that ruling now both allows the SEC's complaint against Blockvest and Ringgold to move forward and removes a potential problem with the agency's tactic of first determining whether an offered cryptocurrency is a security and, if it is, then taking enforcement action if it has not subjected the tokens to SEC regulation.

"The court's reconsideration of its earlier ruling was not as surprising as the earlier ruling itself, which denied the SEC's request for a preliminary injunction in part based on the SEC's having failed to demonstrate that a security was involved," said **Paul Hastings** partner **Nicolas Morgan**. "The legal definition of what constitutes a 'security' is flexible, and where, as here, the SEC alleges a risk of ongoing violations, it is unusual for a federal court judge to deny the SEC's request for a preliminary injunction on the basis that no security is present. Obviously, this ruling (like the ruling it reversed) is preliminary, and it is possible the court might come to a different conclusion later in the case based on information developed during litigation."

Blockvest and Ringgold, according to the judge's reconsideration order, disagreed with the SEC's arguments. The defendants' attorney, who did not respond to a request for a comment, withdrew from the case on February 14. In an order granting the attorney's motion to withdraw, the judge gave Blockvest until March 15 to obtain substitute counsel.

Meeting the definitions

"The court determines that the SEC has demonstrated that the promotion of the ICO of the . . . token was a 'security' and satisfies the *Howey* test," the judge ruled. The test, from the 1946 ruling, *SEC v. W. J. Howey Co.*, set three hurdles for an investment contract to be considered a security: 1) an investment of money 2) in a common enterprise 3) with an expectation of profits produced by the efforts of others.

In addition, the court concluded, the contents of the defendants' website, a white paper and social media posts concerning the ICO to the public constituted an "offer" of "securities" under the Securities Act.

Separately from identifying the tokens as securities, the SEC had the burden of making its case for a preliminary injunction, which the court said required two elements: "1) a prima facie case of previous violations of federal securities laws, and 2) a reasonable likelihood that the wrong will be repeated." The judge, in his reconsideration of the motion for a preliminary injunction, found that the agency had met those tests.

The new ruling went in favor of the agency because "the SEC was able to make persuasive arguments that the Blockvest tokens were in fact securities based on the Howey test," said **Pepper Hamilton** of counsel **Todd Kornfeld**.

Mayer Brown attorney **Matt Bisanz** noted that the judge, in his latest ruling, "focused on something that securities lawyers know, that securities laws apply to both the offer and the sale of the security." The original ruling against the SEC appeared to be based on whether there was a "sale" of securities, he said, not whether there was an "offer."

Judge Curiel appears to address this point in the order, noting that the court, in its original order, did not address the SEC's contention that Blockvest's white paper and social media posts concerning the ICO constituted an "offer." Based on an additional submitted briefing of the issue by the SEC and his reconsideration, he said that the court now "concludes that defendants made an 'offer' of unregistered securities."

Two narratives

The SEC's complaint against Blockvest and Ringgold still has a long road ahead, barring a settlement between the parties. The agency is seeking, among other things, findings from the court that the defendants committed violations. These allegations, aside from failing to register the ICOs with the SEC, include charges that Blockvest and Ringgold made material misrepresentations and omissions to investors and prospective investors.

The agency wants the court to order the defendants to disgorge all funds they received while raising the money, as well as to impose civil money penalties.

Each side presented the court with a different narrative of the facts, something the judge referred to in his initial decision not to impose a preliminary injunction. He made that decision, however, partly because the SEC had not yet provided sufficient evidence to back its contention that the tokens were indeed securities.

The SEC's narrative, which it said was based on the defendants' online posting, was that "Blockvest raised more than $2.5 million from investors, there was a 'common enterprise' because Blockvest claimed that the funds raised will be pooled and [that] there would be a profit sharing formula," according to the judge's first court order denying the injunctive request.

The agency also argued that the defendants "marketed Blockvest ICO as a securities offering and while they argue [that the tokens] were utility tokens, their intent of the offering was to fund Blockvest's future business," according to the judge's order. He also noted that Blockvest and Ringgold admitted that the tokens were sold on Blockvest's website for money or ether, and that the question of whether investors received the token was not relevant in determining whether they were securities.

Blockvest and Ringgold, however, made the case that "they did not raise $2.5 million from the public but instead the $2.5 million was supposed to be based on a transaction with [an individual]," the court order said.

"However, the transaction eventually collapsed and they admit the social media posts were overly optimistic. They assert that they have not sold any . . . tokens to the public but instead used the . . . token for purposes of testing during the development phase." The order noted that the defendants said that 32 testers had put up less than $10,000 in the digital currencies bitcoin and ethereum into the Blockvest exchange for this purpose.

Blockvest and Ringgold said that "there is no common enterprise and the tokens do not represent an interest in or obligation of a corporation or other business," the order said. "Therefore, defendants argue the . . . token is not a 'security.'"

"The SEC was able to persuade the court that by offering its tokens on a public website, even though there were no public buyers of its tokens and an actual sale may have been impossible or not intended, Blockvest had made a public offering in violation of the securities laws," Kornfeld said.

The SEC has made its position on digital currencies clear for several months now, most recently in a November 2018 statement by three of its Divisions – Investment Management, Corporation Finance, and Trading and Markets (*ACA Insight*, 12/3/18) involving its enforcement actions up to that time involving digital assets. "To date, these actions have principally focused on two important questions," the statement said. "First, when is a digital asset a 'security' for purposes of the federal securities laws? Second, if a digital asset is a security, what Commission registration requirements apply?"

The SEC has made clear that while it wishes to "encourage technological innovations that benefit investors and our capital markets, . . . market participants must still adhere to our well-established and well-functioning federal securities law framework when dealing with technological innovations, regardless of whether the securities are issued in certificated form or using new technologies, such as blockchain."

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ACA Compliance Group
(301) 495-7850
(301) 495-7857 (fax)
service@acainsight.com

Editor/Publisher:
Robert Sperber
(301) 502-8718
rsperber@acacompliancegroup.com

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subscribe@acainsight.com
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(800) 508-4140
service@acainsight.com

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