MARSH

REGULATION RISK READY

POST CREDIT-CRISIS RISK MITIGATION

Across industries and issues, the demands of regulators are ever increasing — perhaps none more than those aimed at the financial institutions (FIs) at the center of our economy. FIs saw the spotlight increase following the 2008 credit crisis, a trend that is expected to continue as regulators continue to expand responsibilities and fine tune longstanding rules. Among the sectors facing a high level of scrutiny are:

- Banking and capital markets.
- Asset management.
- Alternative asset management.
- The insurance industry.

Successfully navigating this landscape — both in the US and internationally — requires an in-depth understanding of regulatory demands and proven insurance and risk management strategies to address them. The following is an overview of the top regulation risks facing the mutual fund/asset management sector.

MUTUAL FUND/ASSET MANAGEMENT

1. **NEW FIDUCIARY STANDARD/CONFLICT OF INTEREST RULE:** The US Department of Labor (DOL) released the final version of its highly anticipated Conflict of Interest rule in spring 2016. The rule essentially expands to whom the definition of "fiduciary" applies and addresses the fees or compensation that is paid by investors in connection with the investments in their IRA, 401(k) and other retirement related accounts. The new rule is slated to take effect in April 2017.

   What to Watch for: The rule imposes new requirements on how firms can be paid, client contracts, and client disclosure/transparency regarding compensation practices. In addition, the DOL historically has only had limited regulatory interaction with mutual funds and asset managers, but this is likely to change under this rule. This lack of familiarity will lead to much uncertainty when the DOL launches an investigation. Most firms typically know what the Securities and Exchange Commission (SEC) will look for in an investigation; however, DOL investigations in this area represent uncharted territory.

2. **ALLOCATION OF SHARED FEES AND EXPENSES:** The SEC has conducted several high profile investigations into fees and expenses that are charged to funds or allocated between the funds and their investment managers. There have been several recent settlements involving 12B-1 fees, wrap fees, and allocation of M&A breakup fees.

   What to Watch for: The goal is to protect investors, which means the SEC is giving these matters high priority. Extra scrutiny is being placed on the process and methodologies used in fee allocation. It is important that funds and advisers can show that the allocation was reached as a result of an established process that is coherent, fair, and well documented. Failure to do so could result in fines, a settlement, or lead to civil action by shareholders.

3. **LIQUIDITY OF INVESTMENTS/VALUATION OF SECURITIES:** Two of the SEC's top concerns with fund management focus on the valuation processes for investments that are difficult to price and the overall liquidity of the investment portfolio held by funds. Both areas have been

a focus of the Office of Compliance Inspections and Examinations (OCIE). The SEC also has proposed liquidity management rules under review.

What to Watch for: Part of the proposed liquidity rule includes the classification of the fund holdings into six liquidity categories based on the number of days needed to convert the holding to cash; the minimum allowed is three. Diverse funds could have a percentage of their total holdings in each category, and a conservative fund might show all of its investment in the most conservative category. As this is only a proposal, it's unclear what the risk of a violation would be, but the SEC has the power to investigate, bring civil or criminal actions, and impose penalties or seek settlements.

4. **CHIEF COMPLIANCE OFFICER EXPOSURES:** The SEC, the Financial Industry Regulatory Authority (FINRA), and the Treasury Department's Financial Crimes Enforcement Network are focusing on compliance officers. From 2010 through 2014, the SEC commenced enforcement actions against 72 CCOs. CCO's are frequently implicated in matters that focus on other active wrongdoers, and they are paying the price. For example, one CCO was fined $25,000 for failing to "effectively implement" policies to prevent a former president of the investment adviser from misappropriating client assets.

   What to Watch for: The SEC has been unequivocal that it intends to continue "holding gatekeepers accountable." As this trend continues, CCOs need to make sure they are aware of all potential exposures and provide full transparency to fund management. But they also need to look out for their personal interests, which can be accomplished with some of the innovations in risk management and insurance products.