Asset Management To Buckle Down In 2016

Share us on: By **Carmen Germaine**

Law360, New York (December 24, 2015, 8:37 PM ET) -- A host of new rules set to take effect will bring greater regulatory focus to the asset management industry in 2016, with long-anticipated regulations on the horizon that may further impact funds and fund boards, experts say.

“The most important trend is a shift in regulatory focus on the fund industry,” explained Scot Draeger, chair of the asset management and securities industry group at Bernstein Shur.

Meanwhile, experts said, as funds deal with the enhanced scrutiny, the industry at large will continue to consolidate in an effort to get ahead of heavy competition and to access a broader range of clients.

Here, Law360 takes a look at the major trends to watch out for in asset management in 2016.

Regulators to Focus on Funds

Funds and fund advisers will find themselves increasingly facing the scrutiny of the U.S. Securities and Exchange Commission and other regulators in 2016, experts said, as liquidity requirements and money market mutual fund reforms proposed in mid- and late 2015 are set to be finalized and take effect.

“We’re definitely seeing and hearing in our discussions with regulators a lot of focus on the fund industry,” Draeger said.

The liquidity requirements, **proposed in September**, require funds to monitor the liquidity of their holdings and adds new liquidity disclosure requirements in an effort to ensure open-end fund shareholders will be able to redeem their investments. The money market reforms **approved in July** require mutual funds to limit purchases to only securities that present minimal credit risk by conducting a deeper analysis of whether issuers or guarantors can meet their financial obligations.

Both rules, Draeger said, present resource-intensive changes for funds as they work to comply with the changes, as well as heightened risks for fund boards and fund advisers if they fail to implement the new requirements. The increased risk will also likely lead to a corresponding shift in the level of sophistication

funds seek out in board members, and an increase in director compensation, Draeger predicted.

“It’s a level of granularity has not been imposed upon fund boards until now,” Draeger said.

Fiduciary Standards (May) Arrive

Experts say 2016 could be the year the SEC adopts a uniform fiduciary standard of conduct that will apply to both investment advisers and broker-dealers, saying the agency has the political will to push through regulation.

“I don’t think they’ll get away not doing something,” said Todd Cipperman, founding principal of Cipperman Compliance Services.

Cipperman said that he expects the agency to propose the new fiduciary regulations covering retail advisers and broker-dealers in 2016, but added that he doesn’t anticipate any new standards to apply to institutional advisers or brokerages.

Draeger said that regulators across the board are concerned that investors are confused about what duties investment professionals owe them, but that any proposed regulations will face extensive pushback from broker-dealers, who currently do not owe a fiduciary duty to clients.

The SEC is authorized to adopt a policy under Dodd-Frank, but it isn’t required to do so. The Department of Labor in early 2015 issued a proposed fiduciary rule under the Employee Retirement Income Security Act, but the rule has yet to be finalized.

While brokers are resistant to a uniform fiduciary standard, they have been pushing for changes in how regulators address fiduciary issues related to senior citizens, according to Matt Kitzi, co-chair of the securities regulatory and litigation group at Armstrong Teasdale LLP and the former Missouri Commissioner of Securities.

Those changes are likely to come in 2016, Kitzi said, explaining that broker-dealers support new regulations as they find themselves in a “weird position of not being able to object to or disregard a client’s directions even if they doubt that direction.”

Kitzi pointed to a law enacted in 2015 in Missouri that provides an avenue for broker-dealers to report concerns about cognitive decline and immunizes brokerages against civil suits if they disregard a client’s instructions, saying he expects more state regulators to adopt similar structures.

Funds to Push to Consolidate

Asset management firms in 2016 will continue down a path of consolidation, experts said, as firms grapple with increased competition and seek to gain access to new clients in different spaces.

Cipperman said traditional and alternative asset managers will increasingly merge in 2016. He explained that traditional firms are seeking access to alternative investments and “the broader wallet of the high net worth client cell,” referring to the wealthier clients hedge funds can access, while alternative funds are looking for increased competency in fund operations and distribution.

“There’s a lot of 'grass is always greener' that’s going on in the investment management world,” Cipperman said.

Draeger also said he expects increased consolidation in the industry, but pointed particularly to consolidation of mid-size advisers and merging of asset management and wealth management firms seeking to get out ahead in an increasingly crowded and competitive industry.

"It's harder and harder for asset management firms to distinguish themselves," Draeger said.

He also pointed to a November presentation by the Investment Adviser Association showing 31 acquisitions of registered investment advisers from January to September 2015, noting that six firms were the purchaser in 22 of the deals.

"There's half a dozen firms, if you will, who are on acquisition hunts all over the country for wealth managers who fit within their space," Draeger said.

Firms Will Outsource Compliance

Outsourced compliance programs will become more common in 2016, experts say, as firms seek to lower costs while accessing compliance officers with more experience and expertise.

Cipperman pointed to **an alert published in November** by the SEC's National Exam Program that examined what the agency called a "growing trend," saying the alert has already encouraged advisers and funds that are considering outsourcing their chief compliance officer role.

"I think the alert about outsourcing compliance was a recognition by the SEC that there's just not enough good compliance people out there to effect good compliance," Cipperman said.

He predicted that compliance will soon go the way of fund administration, noting that in the 1990s, most firms administered their own funds but now rely on third-party administrators.

"I think you're going to see almost every firm have a third-party compliance firm," he said.

Kitzi also said he has seen more small and mid-sized investment advisers outsourcing their compliance, saying advisers are even willing to go out of state to seek out a good consultant.

"Every city of any size, even in the Midwest, seems to have its go-to consultants," he said.

The SEC could also soon require investment advisers to obtain third-party compliance reviews, Cipperman predicted, after SEC Investment Management Division Director David Grim said in an October speech that his division has been developing such a recommendation.

Crowdfunding Will Make a Splash in the Shallow End

New rules allowing startup companies to raise small amounts of capital online without many of the hurdles of a formal, registered offering were **finally passed in October** after the Jumpstart Our Business Startups Act called for simplifying the process, a move that experts said holds promise for small businesses — but maybe not for big firms.

Kitzi said the finalization of the rules will shift the crowdfunding space dramatically, and entrepreneurs will be quick to wade in.

"There's going to be all kind of issuers and folks seeking to raise money," Kitzi said.

But as the industry reacts to the change, Kitzi said, it may become difficult to determine how advisers should be paid for managing a product that requires little management.

“I don’t know if that’s going to be something that’s keyed out,” Kitzi said. “I know that regulators may become interested in, or maybe even concerned is a better word, about investment fees for investments that are pretty well locked in.”

At the same time, Draeger expressed doubt that federal regulators would spend significant resources on an area that poses few systemic risks.

The industry will see likely see many entrepreneurs entering the crowdfunding space, Cipperman said, but he predicted that ultimately few traditional firms will join the rush.

“Even private equity firms, I think that’s going to be too penny ante for them,” Cipperman said. “It’s more of a niche thing.”

Advisers Should Watch Out

Recent enforcement actions targeting fund boards and investment advisers over how they use fees and disclose advisers’ pasts show trends that will continue into 2016, experts said, and could well lead to regulatory action as well.

The SEC in September brought its first case in its “Distribution-in-Guise” probe investigating whether mutual fund advisers are using shareholders’ assets to pay for marketing and distribution costs, reaching a **$40 million settlement** against First Eagle Investment Management and signaling a new focus for the agency.

“It was a pretty big reminder to advisers and distributors and fund boards to be vigilant in reviewing use of the fund’s assets,” Draeger said.

Cipperman predicted that the agency will actually propose rules to address what advisers can and can’t do when using funds in distribution, saying the rules have been “a long time coming.”

Draeger also said the SEC has confirmed that it intends to focus in 2016 on how mutual fund boards review and approve contracts and fees charged to the fund by advisers and sub-advisers in what’s known as the “15(c) process.”

As part of that focus, Draeger said, fund boards will have to properly document the process and, relatedly, will be expected to properly document what fund advisers and sub-advisers are doing to justify their fees.

On the state level, Kitzi said, regulators will be focused on ensuring retail advisers properly disclose events in individual investment advisers’ backgrounds, citing several cases in 2015 where state regulators did their own records searches that revealed compliance-related disclosable events that managers had not disclosed.

“It’s becoming incumbent upon firms to be proactive,” Kitzi said. “There’s more scrutiny and expectation of a higher degree of direct and active involvement by firms.”

--Editing by Patricia K. Cole.