Lessons from the Front Lines of Federal Regulation

ACLI Annual Conference 2017

October 10, 2017

Catherine Botticelli | Robert Plaze | Jeffrey Puretz | Carl Wilkerson
Speakers

- **Catherine Botticelli**  
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- **Robert Plaze**  
  Partner, Proskauer Rose LLP

- **Jeffrey Puretz (Moderator)**  
  Partner, Dechert LLP

- **Carl Wilkerson**  
  Vice President & Chief Counsel, Securities & Litigation, ACLI
Agenda

- Trends in SEC enforcement
- Fiduciary standards for brokers
- Liquidity risk management for mutual funds
- Fund substitutions for variable products
Trends in SEC enforcement

Cathy Botticelli
SEC Enforcement Update

- Prior emphasis on Enforcement Statistics and “Broken Windows” Approach
- Changing of the Guard
- Courts pushing back against perceived SEC overreach
- Likely impact from change in administration and adverse court rulings on Enforcement program
Mary Jo White’s SEC

- Focus on Enforcement Statistics
  - 2016 Statistics
    - Over 850 enforcement actions
    - Over $4 billion in penalties and disgorgement
    - Most ever cases involving investment advisers or investment companies (160)
      - 34 more than in fiscal 2015

- Higher penalties
  - In 2016, enforcement actions against public companies hit their highest level since 2009

- Whistleblower incentives
  - In fiscal 2016 alone, $57 million awarded to 13 whistleblowers
  - Since rule went into effect in August 2011, SEC has paid more than $150 million to over 45 whistleblowers
Mary Jo White’s SEC

- Increasing reliance on ALJ’s
  - vast majority of enforcement actions in 2016 were brought as administrative enforcement proceedings before SEC ALJs, rather than as civil actions in federal court

- Broken windows: no case *really* was too small

- Imbedding subject matter experts within Enforcement

- Threat of admissions of wrongdoing

- Uptick in negligence-based cases

- More stand-alone compliance cases (*e.g.*, Raymond James, Baird, Morgan Stanley)
Changing of the Guard

• New Chair:
  • Jay Clayton (an M&A and Regulatory lawyer)

• Current commissioners:
  • Michael Piwowar, Chief Republican Economist, Senate Banking Committee
  • Kara Stein, counsel and Senior Policy Adviser to Sen. Jack Reed (D/Rhode Island), member Senate Banking Committee

• OCIE
  • Acting Director: Pete Driscoll
Changing of the Guard

- **SEC Enforcement Division**
  - Many departures in recent months
  - New Co-Directors of Enforcement:
    - Steve Peikin - former federal prosecutor and law partner of Chairman, Jay Clayton
    - Stephanie Avakian (current acting head) - will stay on as other Co-Director
  - Asset Management Unit: Current Co-Heads
    - Anthony Kelly (appointed March 10, 2016)
    - C. Dabney O’Riordan (appointed June 28, 2016)
Perfect Storm: SEC Enforcement Arsenal Curtailed

- **February 2017:**
  - Acting SEC Chair Piwowar revoked the authority of Associate Directors in Enforcement to issue Formal Orders of Investigation.
    - From 2009, formal order authority had been delegated to the Division Director and approximately 20 senior officers in the Enforcement Division.
    - Prior to 2009, only the Commission could authorize the issuance of a formal order.

- **May 2017:**
  - Commission issued order staying administrative proceedings that could be appealed to the 10th Circuit in light of *Bandimere* decision.
    - In *Bandimere*, divided 10th Circuit panel ruled that ALJs should have been constitutionally appointed (rather than hired) pursuant to the Appointments Clause of the U.S. Constitution.
Perfect Storm: SEC Enforcement Arsenal Curtailed

- **June 2017:**
  - D.C. Circuit: Court split evenly on whether the SEC violated the U.S. Constitution when it appointed its ALJs. This ruling allowed an earlier decision by the court in *Lucia*, which favored the SEC, to stand.
  - U.S. Supreme Court: In a 9-0 ruling, the court ruled in *Kokesh* that "disgorgement" is subject to a five-year statute of limitations.

- **July 2017:**
  - Respondent in *Lucia* files a *certiorari* petition with U.S. Supreme Court citing split between 10th Circuit and D.C. Circuit on whether appointment of ALJs by SEC was constitutional.
Open Questions

- What is the future of “Broken Windows”?
- Will there be a continued emphasis on whistleblowers?
- Will threat of admissions diminish?
- Will there be an increased focus on individual liability?
- Will SEC have to limit its use of ALJ’s?
- Will there be a greater reliance on tolling agreements?
Likely Priorities for New Enforcement Team

- Protection of retail investors and seniors (Mr. and Mrs. 401(k))
- Greater emphasis on individual accountability
- Continuing focus on self-reporting and overall cooperation
- Demanding admissions in “appropriate” cases
- Increased emphasis on cyber
Fiduciary standards for brokers

Carl Wilkerson
Liquidity risk management for mutual funds

Robert Plaze
Liquidity Risk Management Programs

- **Rule 22e-4**
  - Each fund must establish a liquidity risk management program reasonably designed to assess and manage a fund’s liquidity risk.
  - Elements drawn from rules 38a-1 and 2a-7.

- **Reporting and Disclosure**
  - Quarterly reporting of liquidity
  - Prospectus disclosure

- **Board Oversight**
Formal Liquidity Program

- **Liquidity Program Must Include:**
  - The classification of investments into four categories, based on the time required to convert the security to cash;
  - Assessment, management, and periodic review of fund’s liquidity risk;
  - The establishment and periodic review of a highly liquid investment minimum for each fund;
  - 15% limit on illiquid investments; and
  - Policies and procedures for funds that engage in redemptions in kind.

- **Board Oversight; Liquidity Program Administrator**
## Classification

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<thead>
<tr>
<th>Highly Liquid</th>
<th>Moderately Liquid</th>
<th>Less Liquid</th>
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<tr>
<td>Cash and any investment expected to be convertible to cash in current market conditions within 3 business days without significant loss of value</td>
<td>Reasonably expected to be convertible to cash in current market conditions in more than 3 days but fewer than 7 days without significant loss of value</td>
<td>Securities in the first two categories the sale of which is expected to settle in more than 7 days</td>
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<tr>
<td>Everything else. May not reasonably be expected to be sold or disposed of in current market conditions in 7 days or less without significant loss of value</td>
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Liquidity Assessment Review

**Review.** A fund must assess, manage, and periodically review (not less than annually) its “liquidity risk,” i.e., the risk that it may not be able to redeem shares without significantly diluting the remaining investors’ interest in the fund.

**Factors**

- Fund’s investment strategy and liquidity of investments during both normal and reasonably foreseeable stressed conditions;
- Short-term and long-term cash flow projections during both normal and reasonably foreseeable stressed conditions; and
- Holdings of cash and cash equivalents, and borrowing arrangements.
High Liquid Investment Minimum

- **Minimum Amount.** Fund must determine, and review annually, the minimum amount of Fund net assets invested in “highly liquid assets.”
  - Must take into account the Fund’s liquidity risk profile.
  - Board approval not required (except when decreasing while Fund has a shortfall).
  - Exception for Funds investing “primarily” in highly liquid assets.
  - Segregated assets are excluded.
  - Reported to SEC, but not publicly disclosed.

- **Shortfall**
  - Policies and procedures must address how the fund will respond to a shortfall.
  - Report to Board; report to SEC.
Limitation on Illiquid Investments

- **15% Rule.** Fund may not acquire any illiquid investment if, immediately after the acquisition, the Fund has more than 15% of its assets in illiquid “investments that are assets.”

- **Violation.** If not corrected:
  - Within one day, administrator must report to board and provide a plan to come into compliance.
  - Within 30 days, board must re-asses the plan.
Board Oversight

- Approve the program (but not amend).
- Approve designation of Liquidity Program Administrator.
  - Cannot be *solely* portfolio managers of the Fund.
- Review written annual report of Administrator that addresses the operation of the plan and its effectiveness.
  
  *Similar to rule 38a-1.*
Reporting, etc.

- **Reporting**
  - Form N-PORT
  - Form N-CEN
  - Form N-LIQUID

- **Prospectus Disclosure**
  - Procedures for redeeming fund shares, including how long the fund *typically* expects to take to pay redemptions.

- **Compliance Dates**
  - December 1, 2018 – Fund groups with assets of +$1 billion
  - June 1, 2019 – Fund groups with assets of -$1 billion
  - Letter from ICI to SEC Chairman Clayton
Fund substitutions for variable products

Jeffrey Puretz
Legal Hurdles to Substitute a Fund

- 1. Contractual right
- 2. Approval under Section 26(c) of 1940 Act
Section 26(c)

- Applies to: depositor of a registered unit investment trust *holding the security of a single issuer* to substitute a security.

- The standard for the SEC: the evidence establishes that *it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the 1940 Act]*.
Conditions Imposed by the SEC

- Compatibility of strategies and objectives
- No financial impact or burden on contract owners
- Insurer or fund manager must pay brokerage expenses on sale of portfolio securities
- Expense limits if the new fund’s expenses are higher for
  - Two years
  - Life of the contract if advisory and 12b-1 fees are higher
- Process: fund by fund analysis
1. Hartford Files 2 Applications 4-14-15
2. 2d Amendment Filed 8-31-16
3. SEC Notice Issued 12-8-16, 1 year and & 8 months after filing

1. 12-8, Notice Issued
2. 12-28 Hearing Requested by 4 Parties
3. 1-21-17 Hartford Responds that No Hearing Warranted
4. Feb 17 Hearing Requestors Respond to Hartford
5. March 22-23 Hartford Withdraws Applications
The Parties

- Advisers of Replaced Funds
  - AllianceBernstein
  - American Century
  - Capital Research & Management Company
  - Fidelity
  - Franklin Templeton
  - Invesco
  - Lord Abbett
  - MFS
  - OppenheimerFunds
  - Pioneer

- Hearing Requests from
  - American Funds Insurance Series
  - Capital Research & Management Company
  - Raymond Jones Financial
  - 2 investors owning a Hartford VA
Hartford Application by the Numbers

- Maximum nos. of underlying funds under Hartford VA’s: 83
- No. of underlying funds Hartford applied to replace: 62
- No. of replacement funds: 11
- HIMCO: advisers on new funds
- No. of new funds with a sub-adviser: 5 – BlackRock
Hartford Application by the Numbers, cont’d

- No. of substitutions for which composite performance of new funds beat old funds for 3 years (or 1): 35
- No. of substitutions for which old fund performance beat new fund: 12 (1 tie, 1 mixed)
- No. of substitutions for which there is no composite performance for the new fund: 13
- No. of substitutions for which the new funds’ expenses are less than the old: all
- New Funds that have not yet launched: all
- Assets that would be moved: $16.1B
- Assets in AFIS that would be moved: 7.3 B
## Major Issue: Rights

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<tr>
<th>Hartford</th>
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<td>• Hartford has a contractual right to make substitutions and this right was disclosed in prospectuses</td>
<td>• Allows Hartford to substitute its investment judgment for decisions made by investors</td>
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<td>• Eviscerates manner in which VA’s were marketed, VA’s called Leaders</td>
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<td>• Classic bait and switch</td>
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<td>• Raymond James: Would affect 11,000 client contracts: <em>We will potentially need 11,000 different conversations</em></td>
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<td>• Investors: <em>Why is the Government messing with our retirement planning?</em></td>
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## Major Issue: Reasons

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<td>• Annuity benefits call for insurer to have certain unilateral rights</td>
<td>• Hartford seeking to sell its VA business, and substitutions would (1)</td>
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<td>to manage operational expenses and insurance risks</td>
<td>make the VA’s less attractive and accelerate surrenders, (2) make the</td>
</tr>
<tr>
<td>• Simplify the fund lineup</td>
<td>business more hedgeable</td>
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<td>• Reduce expenses for contract owners</td>
<td>• Hartford seeking greater revenue to make business more attractive</td>
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## Major Issue: Precedent

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<td>• SEC issued 52 substitution orders in last 10 years</td>
<td>• Unprecedented</td>
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<td>• Prior orders have been granted that replace a comparable number of</td>
<td>• Lacking representation that there would be no</td>
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<td>funds, where multiple funds are replaced with a single fund, where an</td>
<td>impact to guarantees.</td>
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<td>affiliate serves as adviser, and where new funds have little or no</td>
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<td>history.</td>
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## Major Issue: The Funds

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| • New funds are actively managed, citing Broadridge  
  • New funds have substantially similar investment objective, strategies and risks as old funds | • Would replace actively-managed funds with quantitative index-type funds managed by HIMCO.  
  • Lessens potential upside and de-values guarantees  
  • Objectives and strategies of new funds are not sufficiently similar to old funds  
  • Composites do not lend themselves to a valid comparison  
  • RJ: New funds would be below RJ criteria for its approved list because of the absence of a track record |
Post Mortem

- The SEC stopped issuing notices on substitution applications during the pendency of the hearing request. Since March, 2 new orders have been issued.
- Have underlying funds and their managers been given a veto right over an insurer’s ability to make a substitution?
- Has there been a change in the criteria employed by the SEC staff in analyzing a substitution application?
- Is a new paradigm needed for substitutions?