FS Regulatory Brief

What mutual fund CCOs and GCs are talking about now

October 2012

Recently, PwC had a chance to sit down with a number of Chief Compliance Officers (CCOs) and General Counsels (GCs) of large mutual fund firms to talk about the current regulatory and compliance environment. These CCOs and GCs candidly shared the issues and concerns that were most on their minds now, and had an opportunity to discuss them with other CCOs and GCs and with PwC's regulatory/compliance professionals.

Many CCOs and GCs felt that the current regulatory environment was unlike any they had experienced in the past, both with the range of Dodd Frank-related rulemaking, as well as with the number of regulatory bodies having some regulatory jurisdiction and/or oversight (or possible jurisdiction and oversight) over mutual funds. These include not just mutual funds' primary regulator, the Securities and Exchange Commission (SEC), but also the Commodity Futures Trading Commission (CFTC), the Financial Stability Oversight Council (FSOC), and, for fund firms that operate outside the US, regulators in these jurisdictions.

Among the topics that were most on their minds now were the following:

CFTC registration

In February, the CFTC adopted new rules narrowing the exemption that many investment companies had relied on to avoid registering with the CFTC (CFTC Rule 4.5). To avoid registration, advisers will have to establish that a fund's holdings in commodity interests meet certain de minimus tests. As a result, most advisers to funds with investments in commodities will have to register as commodity pool operators (CPOs). While the CFTC has promised "harmonization," because investment companies are also registered with the SEC, the CFTC's purview overlaps with existing SEC rules for mutual funds, which may lead to new compliance challenges for mutual funds, their advisers and service providers.

This was a major topic of discussion. Several CCOs said that the new registration requirements would impose significant headaches for registered fund firms – so much so that they are now seriously evaluating the possibility of changing the investment guidelines and restrictions on their registered funds in order to remain under the thresholds for CPO/CTA registration. This is a fairly radical step and shows just how much cost and pain is associated with having to register and be dually supervised by the SEC and the CFTC.

Some CCOs expressed disappointment with how the whole CFTC rulemaking came about, and some commented that SEC too easily ceded its jurisdiction here without protest or analysis of whether existing SEC regulations were adequate. Some CCOs are pinning their hopes on the ICI/Chamber of Commerce challenge in district court, but are still making moves to register because the outcome of the court challenge is not certain. The biggest concern raised by CCOs is the huge reporting burden and the duplicative and inconsistent regulation between the SEC and CFTC. Another fear is the requirement for individual employees to take exams and become licensed as commodities professionals (e.g. FINRA series 3, 31, and 32). Some CCOs are convinced that there are instances where they will have to decide between complying with an SEC rule and a CFTC rule but will not be able to comply with both.

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Money market reforms

In late August, after more than a year of public speeches and commentary by SEC Commissioners, banking regulators, the industry, academics, international regulators, and others, SEC Chairman Mary Schapiro announced that the Commission did not have the votes (3 of 5) to move forward with a rule proposal intended to stem "runs" on money market funds.

Fund groups and CCOs have watched the money market fund saga unfold with great attention and interest. CCOs agreed that there have always been differences of opinion among and between SEC staff and among Commissioners, but that those differences have never been aired in public or received as great an interest in the press as they have in this instance. Some expressed a feeling that the 2a-7 debate was not just about systemic risk or potential runs on money market funds, but about banks wanting to seize a business opportunity.

While CCOs are hoping to avoid additional complex regulations for their money funds, having just been through a major round of new policies and controls to implement the 2010 amendments to Rule 2a-7, no one knows what will happen next. Possibilities include: the SEC exploring other rulemaking options; the FSOC seeking to impose "SIFI" status on one or more money market funds; the banking regulators imposing stress tests, capital or other restrictions on banks; or no further action may be taken.

LIBOR

This summer, allegations emerged that a bank participating in setting the LIBOR rate was involved in manipulating the rate, and that other banks are under investigation as well.

Although the LIBOR scandals have fallen out of the headlines, perhaps for the time being, fund and adviser CCOs are actively discussing how or if their firms should respond. Specifically, adviser clients and fund shareholders have made inquiries regarding whether their accounts were impacted by the scandal, and whether the advisers/funds plan to join class action suits against the rate-setting banks accused of manipulating LIBOR.

Global compliance programs

Regulators outside the US have been just as active, though perhaps on a bit of a slower timeframe to date. There is a sense that regulators outside the US will be quite active, and that regulations in the EU, UK, and other jurisdictions will impact asset management firms directly.

As fund/adviser groups expand internationally, there is a lively discussion on how to efficiently implement global compliance and governance standards while still taking into account specific local regulations. CCOs are discussing how best to build a compliance framework that recognizes local differences but still can efficiently and effectively set forth a corporate culture and standard that cuts across geographies. CCOs are weighing establishing a global minimum standard that meets the highest regulatory requirements among the jurisdictions, against taking a more tailored approach of meeting individual regulatory requirements in each jurisdiction.

Board reporting

CCOs report to fund boards on the operation and effectiveness of the fund's compliance program. Many fund trustees are taking more interest in the overall risk management activities related to the fund – including but not limited to compliance risk. Regulators have been talking publicly about risk management, and encouraging fund boards to become more active. For many CCOs, they are considering how best to fit compliance and regulatory risk into a broader risk management framework that includes investment, counterparty, and credit risk. The recent debates over the systemic risk of money market funds and their susceptibility to runs is a good example of how boards' exposure to risk management issues is changing.

CCOs are discussing how to manage reporting and information flow to fund boards. Board books are now mostly electronic, but still represent an equivalent of thousands of pages presented to the directors each quarter. The knowledge and direct industry experience of board members has increased in past 10 years, and this often leads to a challenge of directors wanting to get into the day-to-day details of risk and portfolio management, versus providing executive oversight of the managers' processes and controls as representatives of the shareholders interests.

Some CCOs said that a good example is in funds' use of derivative products – where directors' viewpoints run the range – from trying to understand the detailed mechanics and nuances of every type of investment and contract that the fund has entered into – to expressing a view that the funds should not be invested in derivatives at all – to just wanting to understand the risk management process behind derivatives investment decisions. CCOs struggle with how much and what types of information they should be reporting to their boards so that the boards can provide fiduciary oversight without micro-managing or second-guessing decisions of the adviser they have hired to manage the funds.

Additional information

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