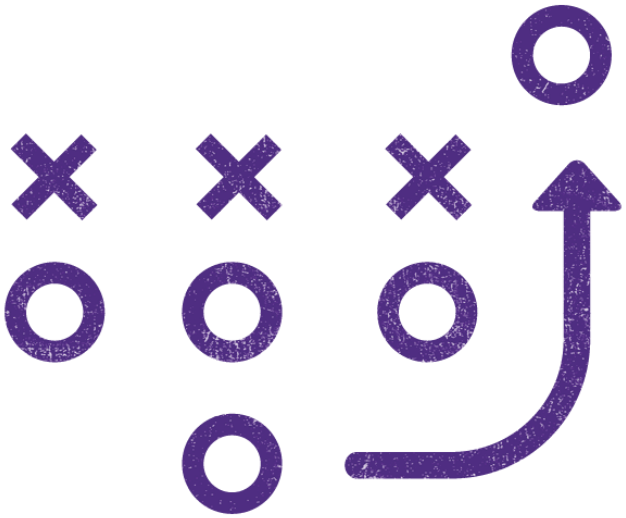
Grant Thornton

The best defense is always a strong offense: Positioning for change in the asset management industry

March 2017



These are uncertain times for the asset management industry. On one hand, the promise of a unified government with Republican control of the White House and Congress promises a friendlier tax, regulatory and enforcement environment.

But on the other hand, with so much change swirling at once, uncertainty abounds. Not to mention, of course, the waves of change striking the industry from unconventional competitors, potentially disruptive technologies such as blockchain, and passively managed low-cost investment funds and robo-advisers, which are forcing active managers to prove their worth in the midst of difficult times.

What should hedge fund, private equity and mutual fund leaders expect? Like almost everyone in the industry, Grant Thornton LLP's Asset Management specialists have their ears to the ground. And, like everyone else, our crystal ball is sometimes murky.

But we do have strong beliefs about how you should prepare and position your organization. In the pages that follow, we share our insights and recommendations in three areas: regulatory concerns, tax-related issues and fundamental changes in the asset management business model.

A friendlier regulatory environment?

There seems to be little doubt that several signature regulatory acts of the Obama era are under the microscope, and the president and Congress seem to be in harmony when it comes to softening their impact.

In early February, President Trump signed executive orders instructing executive branch agencies to examine and recommend changes to:

- The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), a 2010 law that was enacted to safeguard against another financial meltdown of Wall Street
- The Department of Labor's (DoL) fiduciary rule, a 2016 regulation that requires all brokers and advisers to act in the best interests of their clients

Although asset managers are likely to feel the impact from significant changes to Dodd-Frank, the ultimate outcome will require action by Congress.

A more immediate concern, however, is the future of the DoL's fiduciary rule. Until the president swept it into uncertainty with an executive order on Feb. 3 — ordering the DoL to re-examine the rule and consider revising or rescinding it — the rule was scheduled to become effective in early April 2017.[1]

Defenders of the rule, most vocally Sen. Elizabeth Warren (D-Mass.), see it as a firewall to prevent investment advisers from cheating investors out of their retirement savings. Conversely, advocates for reform believe the rule hurts investors by limiting their options. And meanwhile, multiple federal courts have rejected numerous challenges to the rule and the DoL's authority to enact it.[2]

The outcome is far from clear, and it is possible that a compromise could emerge that dilutes the original rule.

[1] http://www.businessinsider.com/trump-executive-order-on-fiduciary-rule-main-street-retirement-money-2017-2
[2] http://www.natlawreview.com/article/update-dol-fiduciary-rule-applicability-delay-and-litigation

Faced with this uncertainty, most of the largest investment advisers are forging ahead as if the fiduciary rule is going into full force on April 10 and making changes to their product offerings and business structures to ensure full compliance. As The Wall Street Journal reported on Feb. 6, some mega-houses are moving forward with compliance actions, citing reasons from uncertainty to heightened customer satisfaction.[3] In fact, no firm mentioned in The Wall Street Journal's coverage expressed interest in rolling back compliance initiatives.

For the rest of the sector, John Stomper, Grant Thornton's Audit Services partner specializing in financial services, suggests that other asset managers follow suit.

"While it may well be delayed and the rule could lose some of its teeth, some form of enhanced protection for the small investor appears likely," Stomper noted. "Asset managers would be well-advised to lay the groundwork for compliance now at whatever level is ultimately required."

Among the changes that Stomper recommends are updating technology platforms to manage increased compliance obligations, ensuring wrap-fee programs meet fiduciary standards and thorough training to assure employees understand appropriate behaviors under the new rules.

Elsewhere on the regulatory front, asset managers can expect continued attention from the SEC. According to Michael Rose, Grant Thornton's Advisory Services partner, SEC attention for asset managers is relatively new.

"It's only been the past few years that the SEC has focused on asset management," Rose commented. "We don't expect that attention to relent under the new administration."

According to Rose, most of the SEC's regulatory action is expected to be around investment advisory agreements and ensuring that the actions of asset managers match the promises they make in those agreements. Along those lines, he sees failure to fully or accurately disclose fees as a prime target, including:

- Fee and expense disclosures
- Improper allocation of transaction-related fees to funds
- Use of fund assets to pay for expenses that advisers should have paid for (i.e., dead deals)
- Fair trade allocations to all the funds

Other potential areas for scrutiny include improper valuation of illiquid assets, use of valuation methods that differ from fund agreements, failure to disclose investment risk and inadequate disclosure of conflicts of interest.

Even if it's not easy, the path to preparation for asset managers is clear. Rose suggests that his clients review and document their allocations processes, compare them to investment advisory agreements to ensure consistency, and employ technology and analytics systems to provide accurate allocations. "Get ready now for questions from the SEC," he concluded. "They're coming, so be ready to respond."

One additional area for attention is fully adopting and implementing cybersecurity policies and procedures that meet strict regulations. Kristina Vieni, Grant Thornton's Advisory Services managing director specializing in technology for financial services companies, reminds her clients that Statements on Standards for Attestation Engagements (SSAE) 18 goes into effect this May, replacing SSAE 16. These updated standards require asset managers to have greater vigilance around risk assessment of third-party technology providers.

[3] https://www.wsj.com/articles/a-complete-list-of-brokers-and-their-approach-to-the-fiduciary-rule-1486413491

"Virtually all asset managers are leveraging outsourced technology providers to help manage noncore capabilities," she said. "Asset managers are responsible for the oversight of these external providers. They need to insist on Service Organization Controls 2 reporting from these providers and assess the risks that may impact them."

Tax law changes

Unified government aside, Congress and the White House are still some distance apart. Before the election, Trump promoted sweeping changes to the tax code to both broaden the tax base and lower rates overall. Among his proposals were the elimination of the so-called carried interest benefit (thus taxing it as ordinary income), fewer and lower tax brackets, elimination of most popular tax deductions, and reduced rates on the active business income from pass-through corporations.

As president, Trump is looking to Congressional leaders to drive tax reform. At the other end of Pennsylvania Avenue, there's clearly an appetite in Congress for tax reform. The president will certainly weigh in, of course, and there are questions about whether he'll embrace all of their proposals such as the destination-based cash flow tax concept that's circulating among House GOP members.

Also, because the GOP lacks 60 votes in the Senate, Democrats can use procedural hurdles like filibusters to effectively block almost any legislation. The reconciliation process would allow Republicans to move tax legislation with simple majorities, but it comes with limits. Provisions generally may not lose revenue outside of the 10-year budget window, which often requires sunsetting. Republicans may need to alter their current proposals to attract at least eight Democratic votes or meet the constraints of budget reconciliation.

Bottom line, tax reform could take up much of 2017 and even spill into 2018.

On one front of particular interest to private equity firms with offshore subsidiaries is an important change that is sure to come regarding the repatriation of cash kept overseas. As recently as early November, The New York Times estimated that U.S.-owned businesses are stashing between $2.4 trillion and $3 trillion in unrepatriated profits outside of the United States.[4] Under current rules, by declaring that foreign profits are permanently or indefinitely reinvested abroad, U.S. companies avoid U.S. taxation on those funds.

There is strong bipartisan support for a tax holiday or more permanent changes to the tax code to bring that money home. But uncertainty remains. How much can Trump do using executive orders? When and how will Congress act? Will there be stipulations on the use of repatriated money?

In 2016, the House GOP leadership released a tax plan that included a one-time tax on unrepatriated earnings of 8.75% for cash (and cash equivalents) and 3.5% for everything else, with the tax to be paid over an eight-year period. Other proposals have been floated ranging from zero limitations on how businesses can invest or distribute repatriated funds to requirements that at least a portion of funds be reinvested to fuel additional domestic growth.

So with changes in the wind but outcomes uncertain, how should prudent asset managers prepare? Layne Albert, Grant Thornton's Tax Services partner focused on the financial services industry, advises clients to lay the groundwork early so they're ready to take maximum advantage of new opportunities.

[4] https://www.nytimes.com/2016/11/06/your-money/strategies-corporate-cash-repatriation-bipartisan-consensuss.html

What does that look like? Albert has several recommendations:

- Examine your business structures. Many asset management organizations have tweaked their structures to minimize tax impact under the current structure. With such changes as the potential loss of carried interest and convergence of individual and flow-through rates, organizations should plan for newly adapted structures. You don't necessarily need to pull the trigger yet — until we all have more clarity into the timing and scope of changes — but be prepared to strike when opportunities arise.
- Given the relative certainty of some form of repatriation, get a handle on your overseas earnings and profits. Consider advanced steps you can take to position cash for easier transfer, making it more attractive for repatriation. To the extent a domestic investment is required, don't overlook incentives at the state and local level that may be available. A well-thought-out approach to domestic infrastructure investing can yield ongoing tax benefits beyond the repatriation.

An evolving asset management business model

Despite the flood of legal and regulatory changes sweeping the asset management sector, Michael Patanella, Grant Thornton's Audit Services partner and national Asset Management sector leader, points out that the calls for change aren't all coming from Washington, D.C. They are still, however, buffeting the sector.

"Innovation, disruptive technologies and unconventional competitors are all changing the course of the asset management sector," Patanella observed. "The most successful mutual funds, hedge funds and private equity firms will get out in front of the innovation curve, so they're not caught behind it."

One of the most exciting — and potentially — disruptive influences is the emergence of blockchain technology (yes, the science behind bitcoin and similar virtual currencies) in the asset management sector. As recently as January, Forbes reported that the Depository Trust & Clearing Corporation (DTCC) is partnering with IBM and two startups to create a blockchain solution for credit default swaps.[5]

According to Steven Goldberg, retired Grant Thornton Advisory Services principal focused on business risk services for financial institutions and investment firms, the DTCC could be just the tip of the iceberg. "As early as 2018, we could see blockchain applied to stock trading," Goldberg predicted. "We could go from several days for trade settlements to real-time settlement."

On a more immediate basis, Patanella is focused on the extraordinary bottom-line pressures that most asset managers are feeling. These pressures are being exerted on multiple fronts:

- Extraordinary pressure on fees from new and unconventional investments, such as passively managed, low-cost exchange-traded funds
- Increased influence of automation and robotics in the sector — especially the automated robo-advisers that provide smaller investors with help managing retirement portfolios at remarkably low-fee levels
- Shrinking retirement savings levels, especially among the younger millennial generation, which is more focused on buying experiences than building nest eggs

[5] http://www.forbes.com/sites/laurashin/2017/01/09/dtcc-selects-partners-for-blockchain-solution-for-credit-default-swaps/

For Patanella, these pressures add up to a single conclusion: asset managers need to work smarter and embrace innovation.

He advises the following:

- **Drive efficiency in the back office**. When margins contract, reducing expenses is vital to maintaining or improving margins.
- **Embrace technology, especially as it opens new avenues for distribution**. Don't dismiss automation and robo-advising technologies, but examine how they could fit into your business model.
- **Tighten internal controls**. Not only will they help drive efficiency, but they'll also make responding to eventual SEC or DoL inquiries faster and less costly.
- **Maximize your assets under management**. When margins tighten, scale can make all the difference. It's not uncommon to see hedge funds opening mutual funds, and mutual funds venturing into the hedge space. Don't feel constrained by traditional boundaries.

In conclusion, Patanella notes that the changes and challenges facing the asset management sector could drive impressive restructuring in the coming few years. As an example, he cites the mid-February sale of Fortress Investment Group to Japan's SoftBank Group for nearly $3.3 billion. According to Bloomberg coverage, Fortress shares had "slumped by almost two-thirds since the listing after the company faced volatile performance during the financial crisis and struggled to explain its value to public shareholders."[6]

"We expect to see more consolidation and further shakeout among asset managers," Patanella concluded. "While some will feel the pain along the way, we see it as a good thing — the result will be a sector that's more efficient, more profitable, and that ultimately provides better service and returns for investors."

[6] https://www.bloomberg.com/news/articles/2017-02-15/fortress-executives-to-cash-in-1-39-billion-from-softbank-sale

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