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Wells Fargo Prime Services Business Consulting
Industry and Regulatory Updates

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Industry Trends

2017 Comprehensive Capital Analysis and Review ("CCAR") and Dodd-Frank Act Stress Tests ("DFAST") Results

2017 CCAR By The Numbers

33 of 34

Banks who received non-objections to their CCAR 2017 capital plans

26 and 8

26 U.S. BHCs and 8 FBOs participated in CCAR 2017, with CIT Group Inc. ("CIT") as the only new participant

5.8%

The Federal Reserve's total loan loss rate estimate of 5.8% was the lowest in the history of the CCAR process and represented a 30bps decline from CCAR 2016

$90B

The Federal Reserve estimated $90bn in net income before taxes for the industry, above the estimates by the U.S. CCAR banks

60%

Buyback programs included in CCAR 2017 were 60% higher relative to CCAR 2016

The Federal Reserve has established quantitative and qualitative programs for the supervision of large financial institutions and incorporates lessons learned from past financial crises.

One of the most impactful of the supervisory programs is the Federal Reserve's annual assessment of financial firms' financial and capital health and the quality of the programs the banks have in place to sufficiently monitor and measure these items. Bank holding companies with $50B+ or more in total consolidated assets are reviewed to determine if they are sufficiently capitalized to absorb losses during stressful conditions, while meeting obligations to creditors and counterparties and continuing lending activities.

In this article the Business Consulting group speaks with the Regulatory and Capital Advisory Group within the Financial Institutions Investment Banking Group ("FIG") to get the team's views on the recent CCAR and DFAST results.

The Federal Reserve performs two stress tests: CCAR and DFAST. What is the importance of the stress tests and the difference between the two?

FIG: U.S. bank holding companies ("BHCs") and foreign-owned banking organizations ("FBOs") above $50 billion in total consolidated assets are subject to annual CCAR and bi-annual DFAST stress testing requirements.

Under CCAR, participating banks are required to project financial and capital performance across a nine-quarter hypothetical stress horizon that is similar in severity to the Great Recession (referred to as the "Severely Adverse scenario"). The Federal Reserve also projects each bank's financial and capital performance across the same stress horizon; the Federal Reserve's projections are the basis for their "objection" or "non-objection" to banks' capital plans. Banks must maintain capital levels above regulatory minimums across all nine quarters; failure to do so results in a quantitative objection from the Federal Reserve to the bank's capital plan that is submitted as part of CCAR. If the Federal Reserve objects to a bank's capital plan, the bank is restricted in its ability to increase dividends or share repurchases, redeem outstanding securities, and conduct M&A.

Minimum Post-Stress Regulatory Ratios for CCAR 2017

Regulatory Ratio	Minimum Ratio
Common Equity Tier 1 Capital Ratio	4.5%
Tier 1 Risk-Based Capital Ratio	6.0%
Total Risk-Based Capital Ratio	8.0%
Tier 1 Leverage Ratio	4.0%
Supplementary Leverage Ratio	3.0%

Source: Federal Reserve

DFAST and CCAR incorporate the same projections of net income, total assets, and risk-weighted assets - the only difference between the two exercises are the different capital action assumptions used to project post-stress capital ratios… which results in materially different quantitative results. For example: if a firm increases its dividend, or includes repurchases of common equity in its planned capital actions, the CCAR projection would be lower than those projected for DFAST (DFAST assumes constant dividends based on historical activity and essentially no common share repurchases). The Federal Reserve ultimately compares a bank's post-stress capital ratios under CCAR against the regulatory minimum capital

ratios to determine if a bank has passed or failed CCAR on a quantitative basis.

How has CCAR evolved over the years and do you expect further changes?

FIG: The macroeconomic variables prescribed by the Federal Reserve for the Severely Adverse scenario were similar to prior exercises; however, the Federal Reserve has made a few amendments to the annual CCAR process. Notably, CCAR banks below $250 billion in total consolidated assets are no longer subject to the qualitative portion of the Federal Reserve's review of a bank's capital plan.

Additionally, the Supplementary Leverage Ratio ("SLR") was included for the first time as part of CCAR. The ratio will become a regulatory capital requirement for banks above $250 billion in total consolidated assets beginning in 1Q 2018 and is generally the constraining regulatory capital ratio for investment banking and custody banking models.

The Federal Reserve modifies the CCAR exercise on an annual basis and will continue to do so. It's important to keep in mind that U.S. stress testing (CCAR / DFAST) requirements are the most stringent globally. A number of industry participants are hoping stress testing requirements are softened as part of the broader bank regulatory reform efforts in the U.S. To date, U.S. regulatory agencies have not published any notable proposals that could provide meaningful relief for stress testing.

The 2017 CCAR results were released in June 2017. What are some of the key takeaways from the Fed's and banks' projections?

FIG: The Federal Reserve continues to project favorable Pre-Provision Net Revenue ("PPNR") estimates relative to bank projections (+$32bn, or +8%) but continues to project higher loss rates than the banks themselves. However, the Federal Reserve's total loan loss rate estimate of 5.8% for the participating banks was ~100bps higher than the average estimated by CCAR banks (note: loan loss rate calculated as the sum of nine quarters of net charge-offs divided by the average of outstanding loan balances across the nine-quarter stress horizon).

Ultimately the Federal Reserve estimated $90 billion in net income before taxes for the industry, above the estimates by the U.S. CCAR banks.

How can the estimates by the Federal Reserve be that much different than what the institutions' are projecting, and is this an increase or decrease to CCAR 2016?

FIG: Companies continue to have materially different views on balance sheet growth assumptions than the Federal Reserve. Similar to prior exercises, the Federal Reserve projected RWA growth for every participating CCAR bank except CIT, which consumed $79bn in aggregate capital across the participating banks. Only a handful of CCAR banks projected RWA growth.

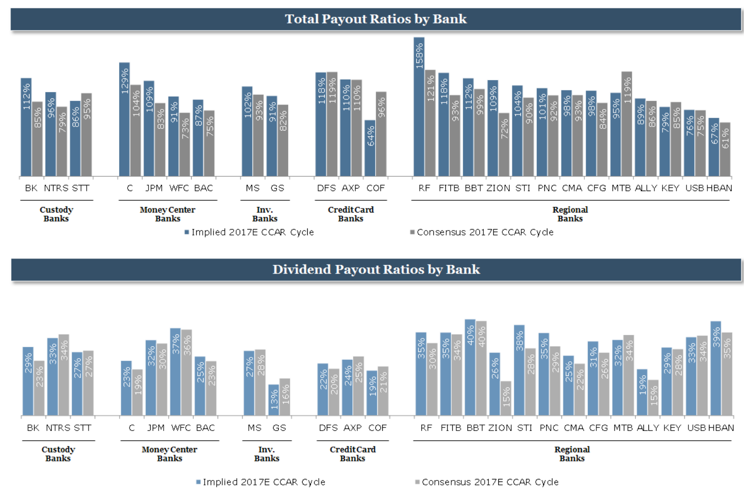
At a high level, the differences in loss rate projections are primarily due to differences in modeling approaches. Companies are using loan- and borrower-level data and analyzing how their exposures may perform in the Fed's prescribed scenarios based on historical performance in stress periods. The Federal Reserve's modeling methodologies are a "black box," but the Federal Reserve uses a less precise approach as the Federal Reserve utilizes a combination of company-level and industry-level data and assumptions.

Do institutions also publish their own stress testing results?

FIG: Yes, the CCAR results include the FRB's decision to object or not object to a BHC's capital plan, for quantitative and/or qualitative reasons. BHCs are required to disclose the results of their company-run stress tests that are based on the same supervisory-specified severely adverse scenario used in the Federal Reserve's projections, but use the BHCs' own internal models, processes and assumptions (e.g., balance sheet growth or decline).

What other findings were released?

FIG: 33 of the 34 banks received non-objections to their CCAR 2017. The Federal Reserve issued a conditional non-objection to Capital One Financial Corporation's ("COF") CCAR 2017 capital plan; COF is required to resubmit its capital plan by 12/28/17.



Source: Company Filings, Federal Reserve

Nearly all CCAR banks exceeded market expectations for total payout ratios. Average gross total payout ratios for all U.S. participating banks are expected to reach 100% (+9% vs. consensus estimates). Share buybacks drove most of the increase (+7% vs. consensus estimates). Buyback programs included in CCAR 2017 capital plans were 60% higher relative to CCAR 2016 capital plans, with aggregate gross share repurchases for U.S. CCAR banks exceeding $100bn over the four-quarter capital planning horizon (3Q 2017 through 2Q 2018). The majority of U.S. CCAR banks increased quarterly dividends by 7-30% beginning in 3Q 2017.

In general CCAR has been the binding constraint (i.e., the limiting factor for a bank to return excess capital to shareholders) for most banks since its inception, but many banks' going-concern capital requirements are now becoming the binding capital constraint, especially for the Money Center banks (BAC, C, JPM, WFC).

Given that only 1 bank received a conditional non-objection, does that mean that all systematically important banks are adequately capitalized and is this an improvement from last year's results?

FIG: The results were positive for the industry as a whole and demonstrate that most banks are holding

excess capital. The increase in industry total payout ratios, and particularly total payout ratios above 100% for certain participating banks, illustrate banks' desire to start returning this excess capital and the Federal Reserve's comfort with the ability of banks to do so and remain well-capitalized.

Does the FRB have different expectations for sound capital planning dependent on the activity and size of the firm?

FIG: The Federal Reserve has increased expectations for capital planning processes and risk management for banks defined as Advanced Approaches banking organizations (greater than $250 billion in total consolidated assets) – these higher expectations are reflected in the Federal Reserve's recent decision to remove non-Advanced Approaches banking organizations from the qualitative review of CCAR. The Federal Reserve has the highest expectations for the eight U.S. banks designated as global systemically important banks ("G-SIBs"), as the failure of one of these institutions would substantially disrupt the U.S. financial system and U.S. economy.

CCAR 2017 Capital Plan Overview

		2017 CCAR Cycle			2017E CCAR vs. CCAR 2016E	
	$ in millions	CCAR 2017 Commentary	2017 CCAR Cycle Approved Share Buyback Plan	2017E Implied Gross Buyback Ratio[1]	2016E Implied Gross Buyback Ratio[2]	Change from CCAR 2016
Custody Banks	Bank of New York Mellon Corporation	Repo of add'l $500mm cond'l on pfd stock issuance	Up to $3,100	83%	77%	6.2%
	Northern Trust Corporation		Up to $750	63%	27%	36.2%
	State Street Corporation		Up to $1,400	59%	70%	(10.3%)
Money Center Banks	Bank of America Corporation		Up to $12,900	63%	29%	33.5%
	Citigroup Inc.		Up to $15,600	107%	56%	51.1%
	JPMorgan Chase & Co.		Up to $19,400	77%	48%	29.4%
	Wells Fargo & Company		Up to $11,500	54%	Not disclosed	n/a
Inv. Banks	Goldman Sachs Group, Inc.		Not disclosed	Not disclosed	68%	n/a
	Morgan Stanley		Up to $5,000	75%	63%	12.1%
Credit Card Banks	American Express Company		Up to $4,400	87%	74%	12.9%
	Capital One Financial Corporation		Up to $1,850	45%	61%	(16.2%)
	Discover Financial Services		Up to $2,230	96%	84%	12.9%
Regional Banks	Ally Financial Inc.		Up to $760	69%	62%	6.8%
	BB&T Corporation		Up to $1,880	71%	26%	45.5%
	Citizens Financial Group, Inc.		Up to $850	67%	69%	(2.2%)
	CIT Group Inc.	Recently returned $3.3bn of capital to shareholders	Up to $225	47%	n/a	n/a
	Comerica Incorporated		Up to $605	73%	84%	(11.4%)
	Fifth Third Bancorp	Repurchases partially offset equity-based comp	Up to $1,161	83%	53%	29.8%
	Huntington Bancshares Incorporated		Up to $308	n/a	0%	n/a
	KeyCorp		Up to $800	51%	30%	20.7%
	M&T Bank Corporation		Up to $900	63%	84%	(20.3%)
	PNC Financial Services Group, Inc.	Repurchases partially offset equity-based comp	Up to $2,700	66%	53%	12.5%
	Regions Financial Corporation		Up to $1,470	123%	59%	64.7%
	SunTrust Banks, Inc.		Up to $1,320	66%	56%	10.0%
	U.S. Bancorp		Up to $2,600	43%	44%	(0.7%)
	Zions Bancorporation		Up to $465	83%	44%	39.2%
		Average	**$3,767**	**71%**	**55%**	**16.5%**

Note: Banks in alphabetical order

[1] 2017E CCAR Cycle implied gross buyback ratio includes approved gross share buybacks and 4-quarter sum of consensus EPS between 3Q17 and 2Q18 at the time of capital plan approval

[2] 2016E CCAR Cycle implied gross buyback ratio includes approved gross share buybacks and 4-quarter sum of consensus EPS between 3Q16 and 2Q17 at the time of capital plan approval

Source: Company Filings, Federal Reserve

A US Perspective on MiFID II

Wendy Beer, Head of Business Consulting, Wells Fargo Prime Services.

The European Securities and Markets Authority (ESMA) was created in 2011 with the goal of creating a more cohesive set of regulations across Europe while improving the financial markets and increasing investor protection. MiFID II was designed with these objectives in mind and will have many wide reaching impacts on regulatory bodies, sell side banks, investment managers, investors, and other players in the financial markets. When understanding the impacts of MiFID II it is important to understand the role that ESMA plays. While ESMA created the framework for MiFID II, it is up to the individual member states to transpose the directive into law. This additional step creates the possibility of individual countries having slightly different implementations of MiFID II. The original plan was to have the implementation by member states in 2017, but the European Commission decided to delay the start date because many believed the requisite IT systems could not be set up in time. With a new implementation date of Jan 3, 2018, MiFID II should be receiving attention from not only EU financial market players, but also US managers who will be indirectly affected by the new regulatory regime.

Within the US, one major topic of discussion concerning MiFID II is focused on the payment for research. The shift in how research will be paid for falls under the "unbundling" section of MiFID II. The goal of this portion

of the directive is to remove the conflict of interest that may cause an investment manager to route orders to a broker who isn't necessarily providing best execution. Eliminating the soft dollar arrangement should cause the investment manager to only consider execution quality when deciding which broker to route their orders to. Managers who are in scope will now compensate banks for sell side research with either direct payments or payments from a research payment account. While managers who are out of scope of MiFID II will not be required to explicitly pay for research, it is possible that market forces will eventually push them towards the hard dollar system. Sell side banks may push all investment manager clients to pay directly for inducements, so they don't need different payment structures for their client base. Investors may also push investment managers to pay directly, so they have the same level of transparency with their out of scope managers as they do with their in scope managers. The switch to hard dollar payments for research has also had the additional effect of US brokers requesting regulatory relief from the SEC. Historically, broker dealers were not able to accept direct payments for research without registering as an investment adviser. This changed on October 26 when the SEC issued a statement that for 30 months it will not take action against non-registered investment advisors who charge directly for research.

As part of the effort to increase market transparency, MiFID II will require all entities trading with European counterparties to obtain a legal entity identifier. US managers may either trade through a US broker and use their LEI or obtain an LEI of their own. The increased demand for LEI's has led to a longer wait time and some managers have had to wait weeks to obtain one. As the implementation date draws nearer, managers who wish to trade directly with European counterparties should remain cognizant of the lengthening wait time.

Even though the implementation of MiFID II was already pushed back by a year many believe that the markets are not fully prepared. There are still many questions around not only the long term effects, but also the changes that will occur on day one of the new regime. Our team will be releasing more detailed articles in the future that delve into specific areas of MiFID II and related topics US managers should be aware of.

Real Estate Trends

Hedge funds that are under pressure to cut fees and improve operational cash flow are looking to real estate as one way to save on expenses. In this article the Business Consulting group speaks with Evan Margolin, Executive Managing Director at Savills Studley, to hear how conversations in real estate are changing.

With rental rates for real estate and office space still at, or near, all-time highs have you seen hedge funds begin to look outside of the traditional premier U.S. locations (Midtown, Greenwich, San Francisco, etc.)

EM: It still seems that most hedge funds want to be in the premiere locations and in areas proximate to other hedge funds. When investors come to town for meetings, the easiest meeting to cut would be the one that is not in the same geographic area as the others.

That being said, in Manhattan there are more funds considering a move to a location outside of Midtown, where the vast majority of funds are currently located (between 42nd Street and 60th Street and between Third Avenue and Sixth Avenue) With a younger generation of PM's spreading out to other neighborhoods, as well as the proliferation of Technology/ Fintech companies moving to NYC and attracting talent that historically went to the alternative asset management industry, hedge funds are now leasing space in alternate areas including SoHo, Chelsea, Flatiron, Tribeca, etc.

Hedge funds are also exploring new developments such as Hudson Yards and the World Trade Center. These inquiries are more related to a desire for brand new construction and less about the emerging locations. While these newly developed buildings are technologically advanced, they are often inappropriate for smaller funds due to the large floor plates.

Do you see this relocation trend mostly with larger established funds or are you also seeing a migration away from premier locations with emerging managers as well?

EM: Emerging managers are asking about alternate locations, but in most cases end up in Midtown, proximate to other funds, for the aforementioned reasons. The more established funds, in certain cases, see themselves as a destination and are less concerned that an investor will not visit due to location. "Quant-type" funds are competing with tech companies for the best and brightest hires and are expressing a desire to move to hipper neighborhoods. They are using their space as a recruiting tool, providing amenities that are desirable to millennials and moving to areas where there is nightlife and a different feel than what a traditional Central Business District might offer.

Do you see rent increasing and is it fueled by competition from firms outside of the financial sector?

EM: Depends on the market. In Manhattan the market is best described as "stable". Asking Rents have been in a relatively tight range, not really increasing, but not going down either. As an example, midtown Class A asking rental rates averaged $88.19/SF one year ago and now average $88.89/SF. That said landlords are more willing to provide outsized concession packages (free rent, build-out allowances, etc.). In Midtown, on deals of 10,000 RSF or more, with lease terms of 10 years or more, the average Tenant Improvement Allowance in 2015 was $63/SF, in 2016 it was $71/SF and in 2017 it is a record $91/SF. Free Rent has also increased from an average of 9 months in 2015 and 2016 to over 10 months in 2017.

The tech (TAMI – Technology, Media, Advertising and Information Technology) sector has certainly influenced the increase in rental rates during this cycle. While the financial services sector has historically been the most active lessor of office space in many of the hedge fund-centric office markets (especially Manhattan), over the last few years the tech sector has been by far more active. Established tech companies continue to hire. Emerging tech companies continue to expand as well, though we are seeing some of the earlier stage companies beginning to scale back and offer their spaces for sublease. Finally, WeWork and other co-working companies have continued to expand with

many locations around all areas of Manhattan (and other central business districts around the country).

What are you seeing now for standard lease durations?

EM: For the established funds, longer leases are still more typical given that the cost to build out a high-end hedge fund office space can be amortized over a longer period of time and moves are disruptive, time consuming and expensive. As an example, in Manhattan, office spaces of 10,000 square feet and larger are typically leased for a 10 year term. The good news is, as previously mentioned, on a 10 year lease a fund can expect to get in excess of 10 months of free rent and a robust build-out allowance (or in many cases a landlord will build the space at no cost to the tenant – other than upgrades above a building standard). On shorter leases the landlord concessions are reduced proportionately making the longer leases more appealing from an "up-front capital cost" perspective.

For the emerging managers and start-up funds, there has been more demand for shorter duration leases. The thinking is often "I have capital set aside to run the fund for 2-3 years regardless of how the marketing goes, but if I am not able to raise anticipated AUM I do not want to be saddled with a longer term lease". Unfortunately, on a direct lease, landlords' typically want a minimum of a 5-year term. However, if the space is already built and doesn't require much alteration, many landlords are now willing to consider a 3-year lease term.

Many emerging funds are asking about subleases opportunities. While subleasing may seem like a cost savings upfront there are associated risks with subleasing space from a fund that has closed, or is downsizing. If the shuttering fund stops paying rent, they will be in default on their lease and the sublease will be invalid. There are ways around this (security deposits by Sublandlord, direct leases with landlords on spaces previously occupied by the fund, assignments of the lease, etc.), but the process is not as simple as it may initially appear.

Is there a metric for square footage per employee and can you explain the difference between usable and rentable square footage?

EM: The metric for square footage per employee is highly dependent upon the amount of employees in the office being considered. There are common elements to any office space regardless of size (including reception area, pantry, technology and copy rooms, etc.) and in a smaller office, these items increase the square footage per employee because they are amortized over a smaller area. Therefore, the typical emerging manager who requires a couple of offices, a conference room and open area for 8-10 people will require approximately 3,000-4,000 rentable square feet (or about 300-400 square feet per employee). Larger funds can typically reduce the per employee space utilization to 200-250 square feet per employee (dependent upon strategy and amount of individual offices).

In Manhattan, space is quoted in "rentable square feet", which is different than the actual "usable square feet" within an office space. On a full floor, the rentable area typically includes a 27% loss factor (meaning a 10,000 rentable square foot space will encompass 7,300 usable square feet). If the floor is divided into multiple suites the common elements of the floor like the corridors, elevator lobbies and bathrooms are amortized amongst the tenants on the floor and the loss factor is often increased to approximately 35%. Tenants pay rent in total dollars, not dollars per square foot. Therefore, analyzing multiple opportunities and finding a space that can efficiently accommodate the staff is often as important as the rent rate.

For funds that are remaining in their current location and have an upcoming lease renewal what are some key tips to consider?

EM: The process for moving or renewing should always be the same. The fund must go out and see other viable options, submit offers on competitive product and have landlords compete for their tenancy. These necessary steps provide an education on the market and enable a fund to make an informed decision as to whether remaining or moving to new a space makes the most financial sense. The best way to obtain the most economically favorable renewal terms is to create leverage. Unless a landlord thinks there is a credible threat of a fund moving, it will be impossible to get the last dollar(s) in the negotiation.

Technology Trends

Spotlight on Fintech

In the first of an ongoing series, Bill Saltus, Wells Fargo Prime Services Business Consulting explores the rapidly evolving landscape of fintech.

In this quarter's inaugural article, Bill explores how both banks and asset managers are allocating capital to fintech startups in a bid to seek both operational efficiency as well as a return on investment.

"Fintech: Within Buy- and Sell-side, Seeking Efficiency and Profit"

Banks and asset managers continue to build out their fintech venture investment portfolios; these and other corporate groups represented more than a third of the 251 VC-backed fintech deals in 2Q17[1]. But Wall St. firms aren't only participating as investors; they are also clients of the various fintech companies in which they invest. The large banks often have venture capital groups in California, as well as strategic investment teams operating out of the capital markets divisions in New York and London. These teams within markets divisions – including a Strategic Investment group here at Wells Fargo – want the opportunity to get familiar with new, potentially disruptive fintech start-ups as customers.

While fintech has been attracting recent press attention from the proliferation of virtual currencies and the funds that invest in them, it is the so-called "blockchain" (aka digital ledger technology) underlying these initial coin offerings that has the potential to transform the financial industry by streamlining settlements and other back office processes. As an immutable, single ledger that concatenates or "chains together" a list of every transaction within a system (and every edit to these transactions,) blockchain technology has the potential to eliminate middlemen such as clearing agents, as well as reconciliations among multiple parties.

The market also sees the potential: in the second quarter

of 2017, dollars invested in new deals for blockchain-related companies increased on a quarter-over-quarter basis (15 deals valued at $232 million)[2]. The involvement of investment banks, many of whom are headquartered in New York, has contributed to its growth as the second largest U.S. region for fintech investing; its 25 deals transacted in Q2 are second only to California's 36[3] (out of a total of 96 U.S. deals in the quarter.)

In addition to the venture funds of sell-side banks, the large asset managers are also making investments in or forming partnerships with fintech companies. However, they are applying blockchain technology in a way that is different from their counterparts on the sell-side. This digital ledger technology is being explored to help streamline the KYC/AML requirements associated with the account on-boarding process for new wealth clients. Blockchain isn't the only fintech making an impact on the buy-side. Wealth tech, a category that includes the automated investment advice of robo-advisors, saw a quarter-over-quarter surge of 208% in 2Q17, with 16 investments attracting $499 million of capital.[4] Whereas financial services companies have pursued offshoring strategies as an efficiency play, they're now looking to leverage fintech not only for cost savings, but to ultimately get closer to the customer. Manulife's Chief Innovation Officer Tim Ramza observes, "Banks and asset managers have long explored labor arbitrage by outsourcing some operational functions, but the next wave will be digital arbitrage."

Meanwhile, some of the larger hedge funds have formed venture capital funds, applying their expertise to these private company investment opportunities in the fintech space. Hedge funds may also be able to leverage these technologies to streamline their operations, but this will likely happen by way of vendors who have adapted their software applications to encompass emerging platforms based on digital ledger technology. One example of this adoption can be found within the treasury technology segment. Hazeltree, a provider of cash, collateral, margin, secFi management and optimization solutions whose technology has traditionally been based on industry-standard SQL databases, is developing a private blockchain to power its newest offering, a cash management solution known as Liquidity Web. Initially, their hedge fund clients and banking partners may not even be aware that the application will be utilizing this cutting-edge, digital ledger technology, but it will nonetheless provide Hazeltree with efficiencies, transparency, and security related to the synchronization of a global platform. Over time, providers of liquidity may become nodes on this permissioned blockchain. "As the CTO of a software company, it's my responsibility to look at new technologies that solve both business and technical problems," notes Sol Zlotchenko, Hazel Tree's Chief Technology Officer. He continues, "Blockchain will allow us to implement a single platform across our global client and partner base that connects all participants in a unified network that doesn't involve cumbersome file exchanges and taxing data synchronization with the overlay of a patchwork of security protection and transparency products. Furthermore, being a fast-paced Fintech company, we also need to stay abreast of the latest industry developments and provide thought leadership in our space. Blockchain technology is a big part of that effort at this point."

But Wall St. hasn't limited its investments only to blockchain-related start-ups. Companies that are applying artificial intelligence to markets activity are also receiving attention from both buy- and sell-side firms. Earlier this year, the six largest U.S. banks participated in the Series B round of financing for Kensho, a leader in machine learning technology for the financial industry.[5] Banks are applying such technology to a variety of functions including research, risk, and compliance. Meanwhile, the commercial banks have been investing in fintech start-ups involved with payments processing, in an effort to get familiar with the innovations that are emerging in this space. Given the scope of this segment, it is understandable that payment tech companies attracted $304 million of capital in the first quarter of 2017 – more than double the global investment in blockchain start-ups during the same time frame.[6]

Regardless of the segment – whether it's blockchain, artificial intelligence, payment tech, or some other area – fintech investments are coming from a variety of sources. From traditional venture capital groups to those found within the large banks and asset managers, investors are trying to get ahead of emerging technology trends. The adoption of such technologies will help these firms become familiar with these emerging toolsets before these tools become industry-standard. And through timely investments, these firms will also look to profit from this evolving technology landscape.

1 CB Insights "The Global Fintech Report: Q2'17"
2 CB Insights "The Global Fintech Report: Q2'17"
3 CB Insights "The Global Fintech Report: Q2'17"
4 CB Insights "The Global Fintech Report: Q2'17"
5 https://www.forbes.com/sites/antoinegara/2017/02/28/kensho-sp-500-million-valuation-jpmorgan-morgan-stanley/#4fffa9165cbf
6 CB Insights "The Global Fintech Report: Q1'17"

Legal & Regulatory Trends

Upcoming Legal and Regulatory Dates

- 10/1/17 – Form ADV Changes
- 10/31/17 – NY Salary History Rule
- 1/1/18 – California Salary History Rule
- 1/1/18 – EU PRIIP Regulation
- 1/3/18 – MiFID II
- 7/1/18 – Massachusetts Salary History Rule

SEC Adopts Amendments to Form ADV

On August 25, 2016, the SEC adopted amendments to Form ADV and to Rule 204-2 of the Advisers Act (concerning recordkeeping) to enhance the quality of information and fill SEC-identified data gaps with regards to filing disclosures and risk-monitoring needs. Investment advisers have been required to comply with the amendments beginning October 1, 2017. This means that advisers with December 31st fiscal year ends will need to comply with the Form ADV amendments no later than their annual amendment filing due by the end of March 2018. In this article the Business Consulting group speaks with Mark Goldstein, Special Counsel, and Ayah Sultan, Associate, at Katten Muchin Rosenman, LLP, provide their insight into the changes and what managers should know prior to March 2018.

What are the general changes with regards to Form ADV reporting that hedge fund managers should be aware of?

Katten: The amendments to Form ADV codify the "Umbrella

Registration" approach that many private fund advisers use. The amendments also require advisers to provide additional information regarding separately managed accounts ("SMAs") and require additional disclosures about, among other things, social media, shared compliance officers, assets under management and private fund ownership.

How is the SEC defining SMAs?

Katten: An SMA is any account other than other than a registered investment company, business development company, private fund or other pooled investment vehicle. (A "fund of one" should not be reported as a pooled investment vehicle if it "operates as a means for the adviser to provide individualized investment advice directly to the investor in the fund.")

What are the specific changes with regards to SMA reporting and are there different requirements based on regulatory assets under management ("RAUM") of the adviser?

Katten: SMA advisers will now be required to report on the percentage of their SMA assets attributable to 12 broad asset categories and derivative positions and borrowings attributable to SMAs ("SMA RAUM"). Details about certain custodian relationships may also be required.

The amount and type of information required to be disclosed will vary depending primarily upon an adviser's SMA RAUM. Advisers with SMA RAUM ranging from $500 million to $10 billion will report, on an annual basis, the amount of SMA RAUM and the dollar amount of borrowings attributable to those assets that correspond to three levels of gross notional exposures. Advisers with SMA RAUM of more than $10 billion will report the same information, on an annual basis, but must include both mid-year and end of year data and, in addition, must report average derivative exposure in six different categories.

Advisers will be required to report on custodians that account for at least 10% of SMA RAUM.

What does "Umbrella Registration" refer to?

Katten: "Umbrella Registration" refers to the approach where private fund advisers file a single Form ADV that covers the adviser (the "filing adviser") and certain other affiliated advisers ("relying advisers"), effectively allowing these entities to share a single SEC registration.

What are the additional conditions now required for Relying Advisers to use Umbrella Registration?

Katten: The Form ADV essentially codifies previous SEC guidance. Umbrella Registration is subject to these conditions:

- The filing adviser and each relying adviser advise only private funds and clients in separately managed accounts that are "qualified clients" under Rule 205-3 and are otherwise eligible to invest in the private funds;
- The filing adviser's principal office and place of business is in the US;
- The relying adviser, its employees and the persons acting on its behalf are subject to the filing adviser's supervision and control;
- The relying adviser's advisory activities are subject to the Investment Advisers Act of 1940 ("Advisers Act") and it is subject to SEC examination; and
- The filing adviser and relying adviser operate under a single code of ethics and a single set of written policies and procedures adopted and implemented in accordance with Rule 206(4)-(7) under the Advisers Act and administered by a single CCO.

How are the amendments affecting Form ADV requirements for Relying Advisers?

Katten: Previously, Form ADV was not designed to describe multiple advisers. Now, there is a new Schedule R that needs to be completed for each relying adviser.

What are other key housekeeping changes and clarifications of which managers should now be aware?

Katten: The amendments require an investment adviser to disclose additional information regarding its website and social media platforms (e.g., Twitter, Facebook and LinkedIn), CIK numbers, offices with related employees and investment activity information, whether the CCO is employed or outsourced, the range of balance sheet assets if the adviser has assets of $1 billion, and the number of clients and the amount of assets attributable to each specified category of client.

How are the amendments affecting responses to solicitation of an investment adviser's clients?

Katten: The amendments make clear that feeder funds should not be considered as "clients" when answering whether the adviser's clients are solicited to invest in the private fund in response to Question 19, 7.B.(1) of Schedule D.

How are the amendments affecting responses to audited financial statements?

Katten: The amendments revise Questions 23(g) and 23(h) to clarify the timing referenced by each question. Question 23(g) asks if the fund's audited financial statements are distributed to the fund's investors, and the amendments add, "for the most recently completed fiscal year" to clarify the question. Question 23(h) asks if the report prepared by the auditing firm contains an unqualified opinion, and the amendments revise the question to ask whether all of the reports prepared by the auditing firm since the date of the adviser's last annual updating amendment contain unqualified opinions.

What are the additional written materials that an investment adviser now must maintain with regards to distribution and performance?

Katten: Advisers will be required to maintain all communications distributed, directly or indirectly, that demonstrate the calculation of the performance or rate of return. Before this, Rule 204-2(a)(16) required that advisers only maintain records supporting performance claims that were distributed to 10 or more persons.

Also, Rule 204-2(a)(7) was amended to require advisers to maintain originals of all written communications received, and copies of written communications sent, by an adviser relating to the performance or rate of return of any or all managed accounts or securities recommendations.

An Update on Tax and Regulatory Reform

The Business Consulting group speaks with Greg McIlvaine, Advocacy Director, Cypress Group and Kelsey Wiseman, Senior Research Analyst, Cypress Group

Comprehensive Tax Reform

Managers are paying close attention to White House and Congressional efforts to move a comprehensive tax reform bill. Where do these efforts stand and what are the prospects that we'll actually see a tax reform bill approved before the end of the year?

CG: The White House and Congress are making progress on comprehensive tax reform with the "Big Six" tax reform negotiators – Majority Leader McConnell, House Speaker Ryan, Senate Finance Chair Hatch, House Ways & Means Chair Brady, NEC Director Cohn, and Treasury Secretary Mnuchin – recently releasing a proposed framework that would reduce the corporate tax rate to 20%, reduce the small business (passthrough entity) rate to 25%, and reduce the top individual rate to 35%. The framework provides tax-writers the discretion to add a fourth bracket above 35% for high-income earners, which House Speaker Ryan signaled will likely be included in the House tax reform package. With regard to the reduced rate for small businesses and passthrough entities, the framework urges tax-writers to adopt measures to prevent the recharacterization of personal income into business income by high-income earners.

Congressional leadership is close to a deal on a fiscal year 2018 budget resolution that will ultimately become the legislative vehicle for tax reform that can procedurally move through the Senate with only a simple majority vote – no filibuster. The Senate-approved budget includes $1.5 trillion in revenue "headroom" in the reconciliation instructions to provide the option to deficit-finance a portion of a tax reform package.

House Ways & Means Committee Chair Brady (R-TX) is expected to release his comprehensive tax reform proposal in the coming weeks with a potential committee mark-up before the Thanksgiving Congressional recess. In order to address recommendations in the Big Six framework on the passthrough rate, the Committee is considering a proposal to deem 70% of passthrough income for personal service companies to be taxed as individual income, and 30% of income to be treated as business income. The Committee also is considering a proposal to prohibit certain service companies that are passthroughs, such as accounting firms, from taking advantage of the lower statutory rate.

While initial progress has been made on the framework and procedural mechanisms for tax reform, it's still early in the process of tax reform and we've yet to see the full political dynamics and push back against various provisions and trade-offs that are proposed by the tax-writing committees, and negotiations on tax reform are likely to extend into early 2018.

Financial Services Regulatory Reform

How is the Trump Administration addressing regulatory reform in the financial sector?

CG: Financial regulatory relief efforts are underway in the Administration and in Congress, and while both are aiming towards the broader goal of deregulation, the narrower focuses will be quite different. Treasury is issuing a series of reports in response to the President's February 3rd Executive Order on "Core Principles" for financial regulation that essentially set out the financial regulators' to-do list from the perspective of the Treasury Secretary and Financial Stability Oversight Council (FSOC) Chair. The first report, released in June, focused on regulatory relief for banks and credit unions, and the second addressed capital markets and increasing access to capital and was issued in early October. The third report, which could also be released this month, will focus on insurance and asset management, while the fourth report on nonbank financial and fintech is expected in December. The Administration can accomplish significant reform on its own – of the numerous recommendations in Treasury's report on capital markets, for example, only nine were legislative. However, the Administration still needs to fill hundreds of vacancies, which will hinder action at the agencies.

What are the financial regulatory relief priorities of Congress?

CG: There are many issues that will require the Administration to coordinate with Congress, where legislation must meet the 60-vote threshold in the Senate to avert a filibuster. The House Financial Services Committee passed Chairman Hensarling's Financial CHOICE Act earlier this year, but the bill, which has been dubbed a wholesale repeal-and-replace of Dodd-Frank, will not be taken up in the Senate. Instead, the Senate Banking Committee is working to produce a more bipartisan package in the coming weeks, while Chair Hensarling is now allowing his Committee to consider standalone bills – some of which were included in CHOICE – to give those measures a greater chance of passage in the Senate. Although sweeping changes to Dodd-Frank are unlikely to garner the support needed to clear the Senate, a number of more modest reforms could become law this year. In particular, bills providing regulatory relief for smaller institutions, reducing regulatory overlap, or making technical fixes are most likely to receive bipartisan support. However, due to the procedural challenge in the Senate and the slow-moving pace of deregulation at the agencies, not every recommendation contained in the Treasury reports will be implemented.

New York City Human Rights Law

Effective October 31, 2017 New York City will join other states and localities who have passed restrictions on employers from seeking or relying on applicants' salary history information when making hiring and compensation decisions. Delaware, Massachusetts and Oregon each passed variations of wage equality laws (set to take effect throughout 2017and 2018), San Francisco passed a similar ordinance (which went into effect in July 2017) and beginning January 1, 2018 California employers are also now prohibited from requiring a candidate to disclose past salary information.

In this article the Business Consulting group speaks with Lauren Leyden, Partner, New York, Akin Gump Strauss Hauer & Feld LLP and Corey Roush, Partner, Washington, Akin Gump Strauss Hauer & Feld LLP on the nuances of the New York City Human Rights law and what managers should do to remain compliant.

Can you explain the upcoming amendment to the New York City Human Rights Law?

Akin: On May 4, 2017, NYC Mayor Bill de Blasio signed into law legislation prohibiting employers from inquiring or relying upon compensation history of applicants in connection with the hiring process. The new law, which amends the NYC Human Rights Law, goes into effect on October 31, 2017. It applies to employers located in New York City and likely also applies if the applicant lives in NYC or if the applicant would be performing work for the employer in NYC. The new law is part of a trend we have seen in other jurisdictions and is intended to help close the gender-based pay disparity gap.

Under the law what defines "salary history"?

Akin: Current and prior wages, benefits and other compensation.

What is excluded from the law?

Akin: Under the new law, prospective employers may continue to: (1) verify an applicant's disclosure of non-salary-related information and conduct background checks in accordance with other applicable laws; (2) engage in discussions with candidates about compensation expectations; (3) inquire about an applicant's expectations with respect to unvested equity or deferred compensation that may be forfeited or cancelled as a result of leaving the current employer; (4) ask about objective measures of an applicant's productivity, such as reports concerning revenue or sales attributable to the applicant; and (5) if a candidate voluntarily and without prompting discloses his/her salary, then such information can be considered in determining future compensation and verified for accuracy. Whether salary history information was voluntarily, and without prompting, disclosed is likely to be an area of significant litigation.

Once the law goes into effect what practices will be considered "discriminatory"?

Akin: It will be considered an "unlawful discriminatory practice" for an employer or its agent to: (1) ask an applicant about his/her salary history; (2) make a statement during the hiring process aimed at determining the applicant's salary history; (3) search publicly available information to try to determine the applicant's salary history, or; (4) rely on salary history for an applicant if such information is inadvertently disclosed or ascertained in violation of the new law. For example, if a head hunter mistakenly sends an applicant's current salary along with a resume, the prospective employer cannot consider or rely on that salary information in any way during the hiring process.

What is allowed?

Akin: Prospective employers are permitted to inform applicants and recruiting firms of the anticipated salary range for the open position. This option can be risky as it may alienate highly qualified individuals if the range does not include or exceed their current salary. Also allowed is engaging in a discussion about the applicant's expectations with respect to salary, benefits and other compensation. While this option is less likely to scare away highly qualified candidates, it does give control of the compensation discussion to the applicant. However, the new law does permit prospective employers to inquire about expectations with respect to unvested equity or deferred compensation that may be lost as a result of leaving the current employer. Such a discussion can help mitigate concerns about giving over control of the compensation discussion to applicants as it could provide a data point for estimating the broader compensation package the applicant may be receiving currently.

What if an applicant voluntarily provides past salary history?

Akin: Salary history that is voluntarily provided without prompting can be considered by prospective employers. The key will be to document that the disclosure is really voluntary.

Does the law apply to internal job applicants?

Akin: No. Employers can consider salary history for internal applicants for transfers or promotions.

Does the law apply to recruiting firms and background check companies? If so what should managers be telling these third parties?

Akin: The new law applies to employers and their agents, which includes headhunters and background check companies engaged by the employer. Headhunters are often engaged by both sides and match the parties, a process which likely makes that headhunter an agent of the employer as well. Even if dealing with a headhunter engaged solely by the applicant, if salary history is disclosed by mistake, the prospective employer cannot rely on that information. So, it is very important that employers proactively reach out to these third parties to develop a process that redacts salary history information, and only discloses such information if and when there is a documented desire to do so by the candidate. Employers may want to minimize risk of inadvertent disclosure by requiring all candidate information be sent to a non-decision maker that can be walled off from the hiring process if need be and/or to add indemnity provisions to agreements with third parties involved in the hiring process in case of violations of the new law.

What are the consequences of violating the new law?

Akin: Individuals may bring a civil lawsuit for alleged violations or may file a complaint with the NYC Commission on Human Rights. Potential damages include injunctive relief, back pay, front pay, compensatory damages and attorneys' fees. In a civil lawsuit the court may award punitive damages. After a hearing before the NYC Commission on Human Rights, it may impose a civil penalty of up to $125,000 or $250,000 for willful, wanton or malicious conduct.

What are best practices for managers when interviewing and hiring on or after October 31st?

Akin: Educate personnel and update hiring policies. We have conducted a number of training sessions for clients so that everyone involved in the hiring process is aware of this new law. It will be key to focus on documentation. We have found that some clients are choosing to include a note taker in interviews, developing standard interview question lists and preparing written acknowledgments for candidates that want to voluntarily disclose salary history information. In advance of the new law becoming effective, employers should be coordinating with the third parties they engage in the process to minimize risk of mistaken disclosure. If something does go awry in the process, contact counsel as soon as possible. On a higher level, employers should think strategically about the hiring process. Anticipating hiring needs, understanding the market for talent and any challenges they will face or flexibility they will likely need to consider for certain roles will put them on a better path to success.

What should managers do to remain cognizant of the broader context of the law?

Akin: Employers should consider reviewing existing pay structures to ensure that there are no disparities. If disparities exist, employers should ensure that they can be explained by valid job-related criteria. Employers should be mindful of potential disparities when setting employee compensation in the future. Particularly to the extent employers engage in internal analysis or evaluation, it is critical to involve qualified counsel to conduct the process in a privileged manner and to ensure compliance.

Can you provide a general overview of the Antitrust component to the law?

Akin: While the law does not have an explicit antitrust component, it arguably creates incentives for employers who can no longer inquire about an applicant's compensation history to set up direct lines of communication with other employers in their industry. Such communications are fraught with antitrust risk. First, if those communications involve exchanges of current or forward looking salary or wage information, they could be deemed to be part of an illegal wage fixing agreement—even if no such agreement is ever explicitly entered into. Second, while exchanging wage information involves the most risk, direct communications concerning non-wage, non-public information, particularly current and forward looking non-public information such as information regarding benefits packages, can also violate the antitrust laws.

While direct communications with other employers in your industry about wages and other current and forward-looking non-public information can be problematic, employers can get access to helpful information by using a neutral third party that gathers backwards-looking information from several industry participants and then shares that data with those participants in an aggregated format that prevents the participants from being able to figure out the source of the data.

Update On The Cayman LLC

The Business Consulting group speaks with Catherine Pham, Partner, Mourant Ozannes and Jennifer Crooke, Senior Associate, Mourant Ozannes on Cayman LLC structures.

What is a Cayman LLC?

Mourant: A Cayman Islands limited liability company (a Cayman LLC) is a hybrid vehicle that combines certain characteristics of a Cayman exempted company with certain characteristics of a Cayman exempted limited partnership. Like an exempted company, a Cayman LLC is a corporate entity with separate legal personality and limited liability for its members. However, similar to an exempted limited partnership, a Cayman LLC does not have the restrictions of share capital and members may agree amongst themselves the inner workings of the Cayman LLC, such as capital accounting; capital commitments; allocations of profits and losses; distributions; and voting rights. Cayman LLCs were introduced in July 2016. They were inspired by (and are very similar to) Delaware limited liability companies (Delaware LLCs). In fact, the Cayman Limited Liability Companies Law, 2016 (the LLC Law) is based, in part, upon the current Delaware Limited Liability Company Act.

Why has Cayman introduced this new vehicle?

Mourant: Prior to the introduction of the Cayman LLC, the main Cayman vehicles available for structuring transactions were the exempted company, the exempted limited partnership and the trust. The Cayman LLC was introduced largely in response to requests from the investment funds industry and provides an additional solution. It was thought that where a Delaware LLC was used as the onshore vehicle in an onshore-offshore fund structure, using a Cayman LLC as the offshore vehicle would enable a closer matching of the legal framework applicable to investors in the different vehicles. The Cayman Islands responded.

Are Cayman LLCs actually being used as fund vehicles?

Mourant: Since the introduction of the Cayman LLC, close to 600 Cayman LLCs have been registered[1]. We understand that a few of these are being used as fund vehicles, but the majority are not. Why? The use of the exempted company as the offshore fund vehicle in the hedge fund context and the use of the exempted limited partnership as the offshore fund vehicle in the private equity fund context have been tried and tested by the market. These vehicles are very familiar to investors, managers/sponsors and other industry participants and there has been little appetite thus far to deviate from the norm. However, we expect that the use of Cayman LLCs as fund vehicles will gain momentum as the industry becomes more familiar with the advantages of the Cayman LLC. In the meantime, Cayman LLCs are being used as general partners of both Cayman exempted limited partnerships and onshore partnerships, management companies, carried interest distribution vehicles, investment holding vehicles, blockers and joint venture vehicles, to name a few examples.

What are the advantages of the Cayman LLC?

Mourant: The key advantages of the Cayman LLC are:

Simplifed administration: The members of a Cayman LLC have capital accounts and make capital contributions rather than subscribing for shares; and profits and losses are

[1] As of August 29, 2017. Source: Cayman Islands Registry

allocated as agreed in the LLC agreement. In the investment funds context, this makes it easier to track and calculate a member's investment.

Flexible management and governance: A Cayman LLC may be managed by one or more managing members or by one or more appointed non-member managers. Generally speaking, the rights and duties of the members and managers in a Cayman LLC are, as between themselves, determined by the LLC agreement. In terms of governance, subject to anything in the LLC agreement to the contrary, a member owes no duty (fiduciary or otherwise) to the Cayman LLC or any member and any member may act in its own best interests even though that may not be in the best interests of the Cayman LLC or any other member. Similarly, subject to anything in the LLC agreement to the contrary, a manager owes no duty (fiduciary or otherwise) to the Cayman LLC or any member other than a duty of good faith (provided that such duty of good faith may be expanded or restricted in the LLC agreement). A manager may, if so provided in the LLC agreement, act in the best interests of a particular member even though it may not be in the best interests of all members or the Cayman LLC.

Familiarity and potential efficiencies: As mentioned, the Cayman LLC is similar in many respects to the Delaware LLC. Therefore, not only will industry participants be familiar with the legal principles that underpin the Cayman LLC, but where a Cayman LLC is used as the offshore counterpart to a Delaware LLC, members in each will enjoy broadly similar legal frameworks. In addition, legal documents for a Delaware LLC can be easily "translated" into legal documents for a Cayman LLC, resulting in drafting efficiencies.

Quick and simple registration: Registration is a simple process that involves the filing with the Registrar of Limited Liability Companies (the Registrar) of a registration statement signed by or on behalf of any person forming the Cayman LLC and the prescribed fee. The Registrar will issue a certificate of registration, which confirms the date of registration and is conclusive evidence of compliance with the requirements of the LLC Law in respect of formation and registration, typically within three to five business days if standard service is used or on the next business day if express service is used. It is worth noting that the LLC agreement is not required to be filed with the Registrar (except where the registration statement also serves as the LLC agreement).

What are your predictions for the future use of Cayman LLCs?

Mourant: The introduction of the Cayman LLC is evidence of Cayman's willingness to adapt and develop its legal regime to remain at the cutting edge of the funds industry. We anticipate that as industry participants become more familiar with the advantages of the Cayman LLC, its popularity will continue to grow. In particular, we predict that the use of the Cayman LLC will develop further in situations where flexibility as regards to administration, management, and governance is required.

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