

LEGG MASON, INC.  
Form 10-K  
May 30, 2018  
Table of Contents

UNITED STATES  
SECURITIES AND EXCHANGE  
COMMISSION  
Washington, D.C.  
20549

FORM 10-K

(Mark  
One)

ANNUAL REPORT PURSUANT TO SECTION  
13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934

For the fiscal year ended March 31, 2018  
or

TRANSITION REPORT PURSUANT TO  
SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the  
transition to  
period from

Commission File  
Number 1-8529

LEGG MASON, INC.  
(Exact name of  
registrant as specified  
in its charter)

Maryland	52-1200960
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
100 International Drive Baltimore, MD	21202
(Address of principal executive	(Zip Code)

offices)  
 Registrant's  
 telephone number, (410)  
 including area 539-0000  
 code:

Securities registered  
 pursuant to Section  
 12(b) of the Act:

	Name of each exchange on
Title of each class	which registered
Common Stock, \$.10 par value	New York Stock Exchange

Securities registered  
 pursuant to Section 12(g)  
 of the Act: NONE

Indicate by check mark if the registrant is  
 a well-known seasoned issuer, as defined Yes  No   
 in Rule 405 of the Securities Act.

Indicate by check mark if the registrant is  
 not required to file reports pursuant to Yes  No   
 Section 13 or 15(d) of the Act.

Indicate by check mark whether the registrant (1) has filed  
 all reports required to be filed by Section 13 or 15(d) of the  
 Securities Exchange Act of  
 1934 during the preceding 12 months (or for such shorter  
 period that the registrant was required to file such reports),  
 and (2) has been subject to such  
 filing  
 requirements  No   
 for the past  
 90 days.

Indicate by check mark whether the registrant has  
 submitted electronically and posted on its corporate Web  
 site, if any, every Interactive Data File  
 required to be submitted and posted pursuant to Rule 405 of  
 Regulation S-T (§232.405 of this chapter) during the  
 preceding 12 months  
 (or such shorter period that  
 the registrant was required to  No   
 submit and post such files).

Indicate by check mark if disclosure of delinquent filers  
 pursuant to Item 405 of Regulation S-K (§229.405 of this  
 chapter) is not contained herein,  
 and will not be contained, to the best of registrant's  
 knowledge, in definitive proxy or information statements

incorporated by reference in Part III of this Form 10-K or any amendment to  this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated  filer Accelerated filer

(Do not check if a smaller reporting company) Non-accelerated  filer Smaller reporting company

Emerging growth  company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. Yes  No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of September 30, 2017 the aggregate market value of the registrant's voting stock, consisting of the registrant's common stock, held by non-affiliates

was \$3,333,673,465.

As of May 25, 2018, the number of shares outstanding of the registrant's common stock was 85,459,843.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for its Annual Meeting of Stockholders to be held on July 31, 2018 are incorporated by reference into Part III of this

Report.

---

Table of Contents

TABLE OF CONTENTS

	Page
<u>Forward-Looking Statements</u>	<u>1</u>
<u>PART I</u>	
<u>Item 1. Business</u>	<u>2</u>
<u>Item 1A. Risk Factors</u>	<u>17</u>
<u>Item 1B. Unresolved Staff Comments</u>	<u>30</u>
<u>Item 2. Properties</u>	<u>30</u>
<u>Item 3. Legal Proceedings</u>	<u>30</u>
<u>Item 4. Mine Safety Disclosures</u>	<u>31</u>
<u>Item 4A. Executive Officers of the Registrant</u>	<u>31</u>
<u>PART II</u>	
<u>Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>33</u>
<u>Item 6. Selected Financial Data</u>	<u>34</u>
<u>Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>35</u>
<u>Item 7A. Quantitative and Qualitative Disclosures About Market Risk</u>	<u>85</u>
<u>Item 8. Financial Statements and Supplementary Data</u>	<u>86</u>
<u>Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	<u>158</u>
<u>Item 9A. Controls and Procedures</u>	<u>158</u>
<u>Item 9B. Other Information</u>	<u>158</u>
<u>PART III</u>	
<u>Item 10. Directors, Executive Officers and Corporate Governance</u>	<u>159</u>
<u>Item 11. Executive Compensation</u>	<u>159</u>
<u>Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>160</u>
<u>Item 13. Certain Relationships and Related Transactions, and Director Independence</u>	<u>160</u>
<u>Item 14. Principal Accountant Fees and Services</u>	<u>160</u>
<u>PART IV</u>	
<u>Item 15. Exhibits and Financial Statement Schedules</u>	<u>161</u>
<u>Item 16. Form 10-K Summary</u>	<u>164</u>

Table of Contents

**FORWARD-LOOKING STATEMENTS.**

We have made in this Report on Form 10-K, and from time to time may otherwise make in our public filings, press releases and statements by our management, "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, including information relating to anticipated growth in revenues, margins or earnings per share, anticipated changes in our business or in the amount of our client assets under management ("AUM") or assets under advisement ("AUA"), anticipated future performance of our business, including expected earnings per share in future periods, anticipated future investment performance of our affiliates, our expected future net client cash flows, anticipated expense levels, changes in expenses, the expected effects of acquisitions and expectations regarding financial market conditions. The words or phrases "can be," "may be," "expects," "may affect," "may depend," "believes," "estimate," "project," "anticipate" and similar words and phrases are intended to identify such forward-looking statements. Such forward-looking statements are subject to various known and unknown risks and uncertainties and we caution readers that any forward-looking information provided by or on behalf of Legg Mason is not a guarantee of future performance.

Actual results may differ materially from those in forward-looking information due to various factors, some of which are beyond our control, including but not limited to those discussed below and those discussed under the heading "Risk Factors" and elsewhere in this Report on Form 10-K and our other public filings, press releases and statements by our management. Due to such risks, uncertainties and other factors, we caution each person receiving such forward-looking information not to place undue reliance on such statements. Further, such forward-looking statements speak only as of the date on which such statements are made, and we undertake no obligations to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

Our future revenues may fluctuate due to numerous factors, such as: the total value and composition of our AUM; the mix of our AUM among our affiliates, asset classes, investment vehicles, client type and geography; the revenue yield of our AUM; the volatility and general level of securities prices and interest rates; the relative investment performance of company-sponsored investment funds and other asset management products both in absolute terms and relative to competing offerings and market indices; investor sentiment and confidence; general political and economic conditions; our ability to maintain investment management and administrative fees at current levels; competitive conditions in our business; the ability to attract and retain key personnel; the impact, extent and timing of technological changes and the adequacy of intellectual property, information and cyber security protection; and the introduction, withdrawal, success and timing of business initiatives, strategies and acquisitions.

Our future operating results are also subject to fluctuation for, among other things, the following: variations in the level of compensation expense incurred as a result of changes in the number of total employees, competitive factors, changes in the percentages of revenues paid as compensation or other reasons; increases in distribution expenses; variations in expenses and capital costs, including depreciation, amortization and other non-cash charges incurred by us to maintain our administrative infrastructure; unanticipated costs that may be incurred by Legg Mason from time to time to protect client goodwill, to otherwise support investment products, upon impairment of intangible assets or in connection with online litigation or regulatory proceedings; and the effects of acquisitions and dispositions, including changes in the expected amount of contingent payments to be made.

Our business is also subject to substantial governmental regulation and changes in legal, regulatory, accounting, tax and compliance requirements that may have a substantial effect on our business and results of operations.



Table of Contents

PART I

ITEM 1. BUSINESS.

General

Legg Mason is a global asset management firm that operates through nine independent asset management subsidiaries. Acting through our asset management subsidiaries, each of which generally markets its products and services under its own brand name, we provide investment management and related products and services to institutional and individual clients, company-sponsored mutual funds and other investment vehicles. We offer these products and services directly and through various financial intermediaries.

Legg Mason, Inc. was incorporated in Maryland in 1981 to serve as a holding company for its various subsidiaries. The predecessor companies to Legg Mason trace back to Legg & Co., a Maryland-based broker-dealer formed in 1899. Our subsequent growth occurred primarily through internal expansion and the acquisition of asset management and broker-dealer firms. In December 2005, Legg Mason completed a transaction in which it sold its primary broker-dealer businesses to concentrate on the asset management industry. Legg Mason is an independent, publicly traded company, with no single majority shareholder and 90% of its Board of Directors consists of independent directors.

Additional information about Legg Mason is available on our website at <http://www.leggmason.com>. We make available, free of charge, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and our proxy statements. Investors can find this information under the “Investor Relations” section of our website. These reports are available through our website as soon as reasonably practicable after we electronically file the material with, or furnish it to, the Securities and Exchange Commission (“SEC”). In addition, the Legg Mason, Inc. Corporate Governance Principles, our Code of Conduct for all employees and directors, and the charters for the committees of our Board of Directors are also available on our corporate website at <http://www.leggmason.com> under “About - Investor Relations - Governance - Corporate Governance”. A copy of any of these materials may also be obtained, free of charge, by sending a written request to Corporate Secretary, Legg Mason, Inc., 100 International Drive, Baltimore, MD 21202. As required, and within the time frames required, by the SEC or the New York Stock Exchange (“NYSE”), we will post on our website any amendments to the Code of Conduct and any waiver of the Code of Conduct applicable to any executive officer, director, chief financial officer, principal accounting officer or controller. The information on our website is not incorporated by reference into this Report.

Unless the context otherwise requires, all references in this Report to “we,” “us,” “our” and “Legg Mason” include Legg Mason, Inc. and its predecessors and subsidiaries, and the term “asset managers” refers to the asset management businesses operated by our subsidiaries. References to “fiscal year 2018” or other fiscal years refer to the 12-month period ended March 31st of the year specified.

Business Developments During the Fiscal Year Ended March 31, 2018

The asset management industry continues to experience disruption and challenges, including a shift to lower-fee passively managed products, increased fee pressure (including pressure arising from the shift to lower-fee passive products), regulatory changes, an increasing and changing role of technology in asset management services, the constant introduction of new products and services and the consolidation of financial services firms through mergers and acquisition. During fiscal year 2018, our focus on investing to improve lives and expanding client choice continued to drive strong sales, despite the ongoing trend of investor movement to passive strategies in certain portions of the industry.



During the course of this fiscal year, we expanded our investment offerings in response to demand for choice by:

- offering new next generation products such as multi-asset class solutions and new vehicles, including the launch of six new exchange traded funds (“ETFs”);
- completing a bolt-on acquisition adding new capabilities at Clarion Partners;
- commercializing alternative products offered by our most recently acquired asset managers;

2

---

## Table of Contents

expanding our Alternative Distribution Strategies and Alternative Product teams with strategic hires; and investing in technology to enhance our capabilities and expand choice for global investors.

During fiscal year 2018, we and our asset managers began to identify and pursue new and different ways to collaborate in order to leverage our combined scale and become more effective and efficient at delivering results for our clients and shareholders. We expect these activities to result in savings, much of which we intend to reinvest in our business.

See “Item 8. Financial Statements and Supplementary Data” for the revenues, net income and assets of Legg Mason, which operates in a single reportable business segment. See Note 5 of Notes to Consolidated Financial Statements in Item 8 of this Report for our revenues generated in, and our long-lived assets (consisting primarily of intangible assets and goodwill) located in, each of the principal geographic regions in which we conduct business. See Note 7 of Notes to Consolidated Financial Statements in Item 8 of this Report for our deferred tax assets in the U.S. and in all other countries, in aggregate.

## Business Overview

Acting through our subsidiaries, we provide investment management and related services to institutional and individual clients, company-sponsored investment funds and retail separately managed account programs. Our corporate structure combines our nine asset managers, each with diverse perspectives and specialized expertise across asset classes and strategies, with a centralized global distribution platform focusing on retail distribution and additional distribution capabilities focused on institutional distribution at each of our asset managers. We help investors globally achieve better financial outcomes by expanding choice across investment strategies, vehicles and investor access through independent investment managers with diverse expertise in equity, fixed income, alternative and liquidity investments. Operating from asset management offices located in the United States, the United Kingdom and a number of other countries worldwide, we deliver our investment capabilities through varied products and vehicles and via multiple points of access, including directly and through various financial intermediaries. Our investment advisory services include discretionary and non-discretionary management of separate investment accounts in numerous investment styles for institutional and individual investors. Our investment products include proprietary mutual funds ranging from money market and other liquidity products to fixed income, equity and alternative funds managed in a wide variety of investment styles. We also offer other domestic and offshore funds to both retail and institutional investors, privately placed real estate funds and funds-of-hedge funds.

Our asset managers primarily earn revenues by charging fees for managing the investment assets of clients. Fees are typically calculated as a percentage of the value of AUM; accordingly, the fee income of each of our asset managers will typically increase or decrease as its average AUM increases or decreases. In addition, the fees on our AUM vary with the type of account managed, the amount of assets in the account, the asset manager and the type of client. Increases in AUM generally result from inflows of additional assets from new and existing clients and from appreciation in the value of client assets (including investment income earned on client assets and due to changes in currency exchange rates). Conversely, decreases in AUM generally result from client redemptions and declines in the value of client assets. Our AUM may also increase as a result of business acquisitions or decrease as a result of dispositions.

We earn performance fees under certain investment advisory contracts for exceeding performance benchmarks or hurdle rates. The largest portion of our performance fees is earned based on 12-month performance periods that end in differing quarters during the year, with a portion based on quarterly performance periods. We also earn performance fees on alternative products that are earned at the end of varying investment periods or in multiple-year intervals. For the fiscal years ended March 31, 2018, 2017 and 2016, of our \$3.1 billion, \$2.9 billion and \$2.7 billion in total revenues, \$227.8 million, \$108.3 million and \$42.0 million, respectively represented performance fees. During the

fiscal years ended March 31, 2018 and 2017, \$108.8 million and \$60.8 million, respectively, of these performance fees were earned by Clarion Partners on assets invested with them prior to the closing of our acquisition of Clarion Partners in April 2016 and are passed through as compensation to Clarion Partners' management team pursuant to the terms of the Clarion Partners acquisition agreement. Exclusive of the performance fees passed through as compensation to Clarion Partners' management team, as of March 31, 2018, approximately 7% of our total long-term AUM was in accounts that were eligible to pay performance fees.

Table of Contents

As of March 31 of each of the last three fiscal years, we had the following aggregate AUM (in billions, except percentages):

	Assets Under Management	Equity Assets	% of Total in Equity Assets	Fixed Income Assets	% of Total in Fixed Income Assets	Alternative Assets	% of Total in Alternative Assets	Liquidity Assets	% of Total in Liquidity Assets
2018	\$ 754.1	\$203.0	27 %	\$422.3	56 %	\$ 66.1	9 %	\$ 62.7	8 %
2017	728.4	179.8	25	394.3	54 %	67.9	9	86.4	12
2016	669.6	162.3	24	372.3	56	22.7	3	112.3	17

From time to time, our reported equity, fixed income or alternative assets under management may exclude assets that we are retained to manage on a short-term or temporary basis. Beginning in fiscal year 2017, we began reporting Alternative Assets as part of our AUM classifications. We currently define Alternative Assets as all AUM managed by Clarion Partners, EnTrustPermal, RARE Infrastructure or a small private equity business prior to its sale on March 31, 2017. All prior periods have been revised to present Alternative Assets.

We believe that market conditions and our investment performance are critical elements in our attempts to grow our AUM and business. When securities or real estate markets are increasing, our AUM will tend to increase because of market performance, resulting in additional asset management revenues. Similarly, if we can produce positive investment results and maintain competitive fee levels, our AUM will tend to increase. In addition, favorable market conditions or strong relative investment performance can result in increased inflows in assets from existing and new clients. Conversely, in periods when securities or real estate markets are weak or declining, or when we have not maintained competitive fee levels or have produced poor investment performance, absolute or relative to benchmarks or peers, it is likely to be more difficult to grow our AUM and business and, in such periods, our AUM and business may decline.

We generally manage the accounts of our clients pursuant to written investment management or sub-advisory contracts between one of our asset managers and the client (or a financial intermediary acting on behalf of the client). These contracts usually specify, among other things, the management fees to be paid to the asset manager and the investment strategy for the account, and are generally terminable by either party on relatively short notice. Typically, investment management contracts may not be assigned (including as a result of transactions, such as a direct or indirect change of control of the asset manager, if it would constitute an assignment under the Investment Advisers Act of 1940 or other applicable regulatory requirements) without the prior consent of the client. When the asset management client is a U.S. registered mutual fund or closed-end fund (whether or not one of our asset managers has sponsored the fund), the fund's board of directors generally must annually approve the investment management contract, and any material changes to the contract, and the fund's board of directors and fund shareholders must approve any assignment of the contract (including as a result of transactions that would constitute an assignment under the Investment Company Act of 1940).

We conduct the majority of our business through our asset managers. Our asset managers are individual businesses, each of which generally focuses on a portion of the asset management industry in terms of the types of assets managed (primarily alternatives, equity or fixed income), the types of products and services offered, the investment styles utilized, the distribution channels used, and the types and geographic locations of its clients. Each asset manager is housed in one or more different subsidiaries. As of March 31, 2018, we directly or indirectly owned all of the voting equity of Brandywine Global Investment Management, ClearBridge Investments, Martin Currie, QS Investors and Western Asset Management Company. Clarion Partners is 18% owned by its management team, EnTrustPermal is 35% owned by its chief executive officer, Royce is 19% owned by its management team, and RARE Infrastructure is 15% owned by its management team and 10% owned by a third party. In addition, the management teams at Clarion Partners and ClearBridge Investments each owns non-voting equity interests in the business which provide them with

participation in any increase in the value of the business (subject to appropriate valuation discounts).

4

---

## Table of Contents

Each of our asset managers is generally operated as a separate business, in many cases with certain distribution functions being provided by our global distribution platform, that typically markets its products and services under its own brand name. Consistent with this approach, we have in place revenue sharing arrangements with certain of our asset managers: Brandywine Global Investment Management, ClearBridge Investments, RARE Infrastructure, Royce & Associates, and Western Asset Management Company, and/or certain of their key officers. Under the terms of these revenue sharing arrangements, a specified percentage of the asset manager's revenues, net of certain third party distribution expenses, is required to be distributed to the equity owners of the business and the balance of the revenues (or net revenues) is retained to pay operating expenses, including salaries and bonuses, but excluding certain expenses such as amortization of acquired intangible assets and excluding income taxes. Specific compensation allocations are determined by the asset manager's management, subject to corporate management approval in certain cases. Although, without renegotiation, the revenue sharing arrangements impede our ability to increase our profit margins from these businesses, we believe these arrangements help us retain and attract talented employees. In addition, the revenue sharing arrangements provide management of these asset managers with incentives to (i) grow the asset managers' revenues, since management is able to participate in the revenue growth through the portion that is retained; and (ii) control operating expenses, which will increase the portion of the revenues retained that is available to fund growth initiatives and for incentive compensation. In addition, the chief executive officer of EnTrustPermal and the management teams of Clarion Partners, ClearBridge, Royce and RARE Infrastructure have significant equity interests in the applicable company, which helps to align the interests of the management of those affiliates with the interests of our shareholders.

### Asset Managers

Our asset managers provide a wide range of investment advisory services to separately managed account clients, including institutional clients such as pension and other retirement plans, corporations, insurance companies, endowments and foundations and governments, as well as retail clients such as high net worth individuals and families, and retail separately managed account programs. In addition, our asset managers also manage or sub-advise various groups of proprietary and non-proprietary U.S. mutual funds and exchange-traded funds ("ETFs") registered under the Investment Company Act of 1940, as amended, including equity, fixed income, liquidity and balanced funds. Certain of our asset managers also manage or sub-advise numerous international mutual funds that are domiciled and distributed in countries around the globe.

Western Asset Management Company is a leading global fixed income asset manager for institutional clients. Headquartered in Pasadena, California, Western Asset Management's operations include investment operations in New York City, the United Kingdom, Japan, Brazil, Australia and Singapore. Western Asset Management offers a broad range of products spanning the yield curve and encompassing the world's major bond markets, including a suite of limited duration and core products, emerging market and high yield portfolios, municipal portfolios and a variety of sector-oriented and global products. Western Asset Management also sub-advises U.S. mutual funds that are sponsored by third parties. Among the services Western Asset Management provides are management of separate accounts and U.S. mutual funds, one real estate investment trust, closed-end funds, international funds and other structured investment products. As of March 31, 2018, Western Asset Management managed assets with a value of \$ 426.0 billion.

ClearBridge Investments is an equity asset management firm based in New York City that also has offices in Baltimore, Maryland and Wilmington, Delaware. ClearBridge Investments provides asset management services to certain of the equity funds (including balanced funds and closed-end funds) in the Legg Mason Funds, to retail separately managed account programs, to certain of our international funds and, primarily through separate accounts, to institutional clients. ClearBridge Investments also sub-advises U.S. mutual funds that are sponsored by third parties. ClearBridge Investments offers a diverse array of investment styles and disciplines, designed to address a range of investment objectives. Significant ClearBridge Investments investment styles include low volatility, high active shares

and income solutions. In managing assets, ClearBridge Investments generally utilizes a bottoms-up, research intensive, fundamental approach to security selection that seeks to identify companies with the potential to provide solid economic returns relative to their risk-adjusted valuations. As of March 31, 2018, ClearBridge Investments managed assets with a value of \$135.0 billion.

Brandywine Global Investment Management is a global asset management firm headquartered in Philadelphia, Pennsylvania with offices also in the United Kingdom, Canada and Singapore. Brandywine Global Investment Management provides investment advisory services primarily to separately managed accounts for institutional clients in a range of fixed income, including global and international fixed income, and equity investment strategies. Brandywine Global Investment Management also provides investment advisory services to high net worth clients through separately managed account

Table of Contents

programs, including various non-proprietary wrap accounts sponsored by third parties, and also sub-advises U.S. mutual funds that are sponsored by third parties. In addition, Brandywine Global Investment Management manages certain of our proprietary U.S. mutual funds and a number of our international funds. Brandywine Global Investment Management pursues a value investing approach in its management of both equity and fixed income assets. As of March 31, 2018, Brandywine Global Investment Management managed assets with a value of \$76.3 billion.

Clarion Partners is a leading manager of real estate investment funds. Headquartered in New York, the firm has offices in Atlanta, Boston, Dallas, London, Los Angeles, São Paulo, Seattle and Washington, DC and offers a broad range of real estate strategies across the risk/return spectrum to institutional investors. Clarion Partners offers its services through institutional separate accounts and privately placed open-end funds. As of March 31, 2018, Clarion Partners managed assets with a value of \$45.6 billion.

Martin Currie is an international equity specialist headquartered in Edinburgh, Scotland with additional offices in London, England and Melbourne, Australia. It manages active U.S. and international equity portfolios for a global client base of financial institutions, charities, foundations, endowments, pension funds, family offices, government agencies and investment funds. As of March 31, 2018, Martin Currie managed approximately \$18.5 billion in AUM.

Royce is the investment advisor to all of The Royce Funds, a proprietary range of equity U.S. mutual funds and to certain of our international funds. In addition, Royce manages other pooled and separately managed accounts, primarily for institutional clients. Headquartered in New York City, Royce generally invests in smaller company stocks, using a value approach. Royce's stock selection process generally seeks to identify companies with strong balance sheets and the ability to generate free cash flow. Royce pursues securities that are priced below its estimate of the issuer's current worth. As of March 31, 2018, Royce managed assets with a value of \$16.6 billion.

EnTrustPermal is a leading global alternative asset manager specializing in providing investment solutions to public, corporate and multi-employer pension funds, foundations, endowments, sovereign wealth funds, insurance companies, private banks, family offices and high net worth individuals. EnTrustPermal has investment teams located in London, New York City and Paris and additional offices in Dubai, Hong Kong, Singapore and Nassau. As of March 31, 2018, EnTrustPermal managed assets with a value of \$ 16.3 billion.

QS Investors is a customized solutions and global quantitative equities investment firm providing asset management and advisory services to a diverse array of institutional clients. Headquartered in New York City, QS Investors has developed approaches to integrating quantitative and behavioral investment insights and dynamically weighting opportunities in response to changing conditions in the economy and the market. QS Investors offers a broad spectrum of strategies which includes actively managed U.S. and Global equities, Liquid Alternatives, and Customized Solutions. As of March 31, 2018, QS Investors managed approximately \$13.9 billion of AUM.

RARE Infrastructure is a global listed infrastructure investing specialist that manages domestic and international funds in three distinct strategies; RARE Infrastructure Value (a global strategy with a mix between income and capital returns), RARE Emerging Market (purely focused on emerging markets infrastructure) and RARE Infrastructure Income (a global strategy with a focus on distributing yield). Legg Mason holds a 75% ownership interest in the firm, the firm's management team holds a 15% equity stake and a third-party owner holds 10%. Headquartered in Sydney, Australia, RARE Infrastructure had approximately \$4.2 billion in AUM as of March 31, 2018.

United States Funds

Mutual Funds



Our U.S. mutual funds primarily consist of two groups of proprietary mutual and closed-end funds (the “Legg Mason Funds” and the “Royce Funds”). The Legg Mason Funds invest in a wide range of domestic and international equity and fixed income securities utilizing various investment styles, including several money market funds. The Royce Funds invest primarily in smaller-cap company stocks using a value investment approach.

The Legg Mason Funds consist of 110 mutual funds and 28 closed-end funds in the United States, which are managed or sub-advised by Brandywine Global Investment Management, ClearBridge Investments, EnTrustPermal, Martin Currie, RARE Infrastructure, QS Investors and Western Asset Management. The mutual funds and closed-end funds within

## Table of Contents

the Legg Mason Funds include 52 equity funds (including balanced funds) that invest in a wide spectrum of equity securities utilizing numerous investment styles, including large- and mid-cap growth funds and international funds. The fixed income and liquidity mutual funds and the closed-end funds within the Legg Mason Funds include 58 funds that offer a wide variety of investment strategies and objectives, including income funds, investment grade funds and municipal securities funds. As of March 31, 2018 and 2017, the Legg Mason Funds included \$149.1 billion and \$147.1 billion in assets, respectively, in their mutual funds and closed-end funds, of which approximately 38% and 37%, respectively, were equity assets, approximately 45% and 40%, respectively, were fixed income assets, and approximately 17% and 23%, respectively, were liquidity assets. As of both March 31, 2018 and 2017, less than 1% of the assets in the Legg Mason funds were alternative assets.

The Royce Funds consist of 17 mutual funds and three closed-end funds, most of which invest primarily in smaller-cap company or micro-cap company stocks using a value approach. The funds differ in their approach to investing in smaller companies and the universe of securities from which they can select. As of March 31, 2018 and 2017, the Royce Funds included \$13.8 billion and \$15.4 billion in assets, respectively, substantially all of which were equity assets. The Royce Funds are distributed through non-affiliated fund supermarkets, Legg Mason Global Distribution, non-affiliated wrap programs, and direct distribution. In addition, two of the portfolios in the Royce Funds are distributed only through insurance companies.

### Exchange Traded Funds

The Legg Mason ETFs invest in a wide range of domestic and international equity securities. As of March 31, 2018, Legg Mason's ETF lineup consisted of 13 ETFs with an aggregate AUM of approximately \$815 million. Our ETFs are managed by ClearBridge Investments, Martin Currie, QS Investors, RARE Infrastructure, Royce and Western Asset Management. In fiscal 2019, Legg Mason expects to add to its ETF lineup managed by these and other affiliated asset managers. This lineup will include ETFs utilizing both passive and active management to invest in a wide spectrum of equity securities utilizing numerous investment styles, including broad fixed income and equity exposure, factor, sector exposure, fixed income and traditional security selection.

### Private Funds

In addition to our U.S. mutual funds and ETFs, our asset managers sponsor and manage various unregistered, or "private" funds that are made available to qualified U.S. or non-U.S. investors, depending upon the product. Private funds are pooled investment vehicles that are exempt from local regulation and that are typically offered to sophisticated, high net worth investors, corporations, sovereign wealth funds, public pension plans and other pooled investment vehicles. Clarion Partners offers a broad range of privately placed funds invested primarily in equity and debt instruments of five major real estate property types. EnTrustPermal sponsors and manages a number of U.S. and non-U.S.-organized private funds that offer a wide range of alternative strategies. Brandywine Global Investment Management, ClearBridge Investments, Martin Currie, QS Investors, RARE Infrastructure and Western Asset also sponsor and manage a wide range of private fund offerings for qualifying U.S. and non-U.S. investors.

### International Funds

Outside the United States, we manage, support and distribute numerous proprietary funds across a wide array of global fixed income, liquidity, equity and alternative investment strategies. Our international funds include a broad range of cross border funds that are domiciled in Ireland and are sold in countries across Asia, Europe and Latin America. Our international funds also include local fund ranges that are domiciled in the United Kingdom, Australia, Japan and Singapore and offered to investors in the country of domicile. Our international funds are distributed and serviced by Legg Mason Global Distribution, as discussed below. Our international funds, which include equity, fixed income, alternative, liquidity and balanced funds are primarily managed or sub-advised by Brandywine Global

Investment Management, ClearBridge Investments, EnTrustPermal, QS Investors, Martin Currie, RARE Infrastructure, Royce and Western Asset Management. In the aggregate, we sponsored and managed 202 and 201 of these international funds, respectively at March 31, 2018 and 2017, which at those dates had an aggregate of approximately \$86.8 and \$95.0 billion in assets, respectively, of which approximately 24% and 22%, respectively, were equity assets, approximately 36% and 25%, respectively were fixed income assets, approximately 4% and 3%, respectively, were alternative assets and approximately 36% and 50%, respectively, were liquidity assets. The information above does not include the funds-of-hedge funds sponsored and managed by EnTrustPermal, the Brazil-domiciled funds managed by Western Asset Management or the privately placed real estate

## Table of Contents

funds offered by Clarion Partners.

### Retail Separately Managed Account Programs

We are a leading provider of asset management services to retail separately managed account programs, commonly known as managed account or wrap programs. These programs typically allow securities brokers or other financial intermediaries to offer their clients the opportunity to choose from a number of asset management services pursuing different investment strategies provided by one or more asset managers, and generally charge an all-inclusive fee that covers asset management, trade execution, asset allocation and custodial and administrative services. We provide investment management services through more than 140 retail separately managed account programs sponsored by various financial institutions.

### Distribution

Our centralized global distribution group, Legg Mason Global Distribution, operates two divisions, the U.S. Distribution Group and the International Distribution Group. The U.S. Distribution Group markets, distributes and supports our U.S. mutual funds, ETFs and retail separately managed account programs. The International Distribution Group markets, distributes and supports our international funds. In general, our U.S. and international sales and marketing teams are housed in separate subsidiaries from our asset managers.

In addition, each of our asset managers has its own sales and marketing teams that distribute its products and services, primarily, in most cases, to institutional investors. The institutional sales and marketing teams of our asset managers distribute asset management services to potential clients, both directly and through consultants. Consultants play a large role in institutional asset management by helping clients select and retain asset managers. Institutional asset management clients and their consultants tend to be highly sophisticated and investment performance-driven.

### U.S. Distribution

The U.S. Distribution Group of Legg Mason Global Distribution employs a team of U.S. based sales, marketing and support staff that market, distribute and support our U.S. mutual funds, including the Legg Mason Funds, the Royce Funds, the Clarion Funds and the Legg Mason ETFs. We distribute the Legg Mason Funds directly and through a number of third-party distributors.

The U.S. Distribution Group distributes institutional share classes of the Legg Mason Funds to institutional clients and also distributes variable annuity sub-advisory services provided by our asset managers to insurance companies (including advisory services provided to certain of the Legg Mason Funds that are specifically designed for purchase through variable annuity contracts and variable life insurance policies offered by participating insurance companies). Our institutional liquidity funds are primarily distributed by Western Asset Management's sales team. The Royce Funds are distributed by Royce's sales team in addition to the U.S. Distribution Group.

In addition to distributing funds, the wholesalers in Legg Mason Global Distribution also market and support our retail separately managed account program services and the Legg Mason ETFs. These services are provided through programs sponsored by a variety of financial institutions.

### International Distribution

The International Distribution Group of Legg Mason Global Distribution employs a team of sales, marketing and support staff that markets, distributes and supports our international funds to individual and institutional investors across Asia (including Australia and Japan), Europe and the Americas. The International Distribution Group has sales

teams operating out of distribution offices in 16 cities in 13 countries and distributing our cross border international funds globally and our international local fund ranges in their respective countries. The goal of our International Distribution Group is to be a global partner for firms that utilize or distribute asset management products around the world, but also to be viewed as a local partner through an understanding of the nuances and needs of each local market that they cover. These distributors seek to develop deep distribution relationships with retail banks, private banks, asset managers, fund platforms, pension plans and insurance plans. Our international distribution offices also work with our asset managers on a case-by-case basis to take advantage of preferences for local distributors or to meet regulatory requirements in distributing products and

## Table of Contents

services into their local markets.

Our distribution efforts are not limited to the locations where we have offices, as the International Distribution Group distributes cross border funds in more than 25 countries around the world. This global presence provides Legg Mason with the capabilities to provide a platform of sales, service, marketing and products that can cater to the different distribution dynamics in each of the regions that it covers. Client coverage is local, coordinated across regions, and encompasses multiple distribution channels including broker-dealers, funds-of-funds, asset managers, independent financial advisers, banks, fund platforms, insurance companies and other distribution partners. The extent to which each channel takes precedence in any one market is governed by local market dynamics.

In Australia, our distribution operations distribute local and cross border funds sub-advised by our asset managers primarily to retail investors, pension plans, fund-of-funds managers, insurance companies and government funds/agencies. In Japan, our distribution operations distribute domestic investment funds, cross border funds and institutional separate accounts primarily to the retail market, which includes retail banks, private banks, asset managers, funds platforms and insurance companies.

EnTrustPermal's products and services are sold outside the United States to non-U.S. high net worth investors through a network of financial intermediaries by EnTrustPermal's distribution operations as well as through our International Distribution Group. In addition, EnTrustPermal distributes its products and services to U.S. and international institutions through EnTrustPermal's internal distribution teams.

## Employees

At March 31, 2018, 2017 and 2016, we had 3,275, 3,338 and 3,066 employees, respectively. None of our employees are covered by a collective bargaining agreement. We consider our relations with our employees to be satisfactory. However, competition for experienced asset management personnel is intense and from time to time we may experience a loss of valuable personnel. We recognize the importance to our business of hiring, training and retaining skilled professionals.

## Competition

We are engaged in an extremely competitive business and are subject to substantial competition in all aspects of our business. Our competition includes, with respect to one or more aspects of our business, numerous international and domestic asset management firms and broker-dealers, mutual fund complexes, hedge funds, commercial banks, insurance companies, other investment companies and other financial institutions. Many of these organizations offer products and services that are similar to, or compete with, those we offer, and many of these organizations have substantially more personnel and greater financial resources than we have. Some of these competitors have proprietary products and distribution channels that make it more difficult for us to compete with them. In addition, many of our competitors have long-standing and established relationships with distributors and clients. The principal competitive factors relating to our business are the quality of advice and services provided to investors, the performance records of that advice and service, the reputation of the company providing the services, the price of the services, the products and services offered and distribution relationships and compensation offered to distributors.

Competition in our business periodically has been affected by significant developments in the asset management industry. See "Item 1A. Risk Factors - Risks Related to our Asset Management Business - Competition in the Asset Management Industry Could Reduce our Revenues and Net Income."

## Regulation

The asset management industry is subject to extensive federal, state and international laws and regulations promulgated by various governments, securities exchanges, central banks and regulatory bodies that are intended to benefit and protect investors in products. In addition, our distribution activities also may be subject to regulation by international and U.S. federal agencies, self-regulatory organizations and securities commissions in those jurisdictions in which we conduct business. Due to the extensive laws and regulations to which we are subject, we must devote substantial time, expense and effort to remaining vigilant about, and addressing, legal and regulatory compliance matters. Moreover, regulatory changes in one jurisdiction often affect our business operations in other jurisdictions.

## Table of Contents

Virtually all aspects of our business are subject to various laws and regulations around the world, some of which are summarized below. These laws and regulations are primarily intended to protect investment advisory clients and investors in registered and unregistered investment companies. Under these laws and regulations, agencies that regulate investment advisers, investment funds and other individuals and entities have broad administrative powers, including the power to limit, restrict or prohibit the regulated entity or person from conducting business if it fails to comply with such laws and regulations. Regulators also have a variety of informal enforcement mechanisms available that could have a significant impact on our business. Possible sanctions for significant compliance failures include the suspension of individual employees, limitations on engaging in certain lines of business for specified periods of time, revocation of investment adviser and other registrations, censures and fines. A regulatory proceeding, regardless of whether it results in a sanction, can require substantial expenditures and can have an adverse effect on our reputation or business.

### Regulatory Reform

We are subject to numerous regulatory reform initiatives around the world. Any such initiative, or any new laws or regulations or changes in enforcement of existing laws or regulations, could materially and adversely impact us by leading to business disruptions, requiring us to change certain business practices and exposing us to additional costs (including compliance and legal costs). The rules governing the regulation of financial institutions and their holding companies and subsidiaries are very detailed and technical. Accordingly, the discussion below is general in nature, does not purport to be complete and is current only as of the date of this report.

### U.S. Executive Order

On February 3, 2017, a U.S. presidential executive order (the “Executive Order”) articulated certain core principles for regulating the U.S. financial system and directed the Secretary of the U.S. Department of the Treasury (the “U.S. Treasury”) to report to the President the extent to which existing laws, treaties, rules, regulations and policies promote, support or inhibit the federal regulation of the U.S. financial system in a manner consistent with the core principles. The Treasury has issued three (of an expected four) reports in response to the Executive Order (the “Treasury Reports”), which include a number of recommendations, the majority of which require further legislative or regulatory action in order to be implemented, that may affect our business or operations. The scope and potential impact of any regulatory changes resulting from the Executive Order and the Treasury Reports are unclear and we will continue to monitor the potential impact of the Executive Order on our business.

### Dodd-Frank Wall Street Reform and Consumer Protection Act

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) was signed into law in the United States. The Dodd-Frank Act requires the adoption of extensive regulations and numerous regulatory decisions, many of which have been adopted and others of which will be forthcoming. We have implemented programs to address certain regulations adopted under Dodd-Frank, as well as financial reforms that have been introduced as part of the SEC’s investment company modernization initiatives. As certain limited aspects of Dodd-Frank and other rules are still being adopted, and the impact of the rules already adopted will become evident over time, it is not yet possible to predict the ultimate effects that the Dodd-Frank Act or subsequent implementing regulations and decisions will have on us.

### Systemically Important Financial Institution (“SIFI”) Review

The Financial Stability Oversight Council (“FSOC”) has the authority to designate nonbank financial institutions as SIFIs. FSOC’s most recent statements generally indicate that it is focused on products and activities, rather than designation of entities, in its review of asset managers. The Treasury report on asset management, issued in October



2017, also expressed this view. In addition, in November 2017, Treasury made recommendations concerning the process by which FSOC designates nonbanks as SIFIs, further supporting a products and activities approach to addressing risks in asset management. If we are designated as a SIFI, we could become subject to direct supervision by the Federal Reserve System.

Both the Financial Stability Board (“FSB”), working with the International Organization of Securities Commissions (“IOSCO”), and FSOC, are considering potential systemic risk related to asset management and are currently focused on a products and activities approach in their review of asset managers. In January 2017, the FSB announced its Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, which concentrates primarily

## Table of Contents

on products and activities and includes 14 recommendations largely focused on liquidity in open-end funds, leverage in funds, operational risk, and securities lending, certain of which IOSCO is expected to engage on in the future. The FSB has indicated that it may develop criteria for designation of nonbank non-insurers in the future to address “residual risks”. Any measures applied in relation to a global systemically important financial institution (“G-SIFI”) designation from the FSB would need to be implemented through existing regulatory processes and procedures by relevant national authorities.

If we or any other asset manager were designated a SIFI or G-SIFI, we could become subject to enhanced prudential, capital, supervisory and other requirements, such as risk-based capital requirements, leverage limits, liquidity requirements, resolution plan and credit exposure report requirements, concentration limits, a contingent capital requirement, enhanced public disclosures, short-term debt limits and overall risk management requirements. Requirements such as these, which were designed to regulate banking institutions, would likely need to be modified to be applicable to an asset manager. No proposals have been made indicating how such measures would be adapted for asset managers.

### Securities and Exchange Commission Review of Asset Managers and Mutual Funds

Our business may also be impacted by additional regulatory initiatives by the SEC. In October 2016, the SEC adopted new rules (as well as amendments to existing rules) to modernize the reporting and disclosure of information by registered investment companies, including (i) new monthly and annual reporting requirements for certain U.S. registered funds; (ii) enhanced reporting regimes for investment advisers; and (iii) implementing liquidity risk management programs for ETFs and open-end funds, other than money market funds. In February 2018 the SEC extended the compliance deadlines for certain provisions of the rules, although the original December 1, 2018 deadline for other provisions still applies. The rules will increase our public reporting and disclosure requirements, which could be costly. Any additional SEC oversight relating to the above, or the introduction of any new reporting, disclosure or control requirements could expose us to additional compliance costs and may require us to change how we operate our business.

### Regulation of Exchange-Traded Funds

As part of a focus on financial stability issues and due to the significant growth of this product class over the last few years, regulators globally are examining the potential risks in ETFs, including risks related to transparency, liquidity and structural resiliency. There can be no assurance that structural or regulatory reforms, including potential rulemaking by the SEC, will be implemented in a manner favorable to us, or at all. Depending on the outcome of this renewed regulatory analysis, or any associated structural reforms, ETF products may become subject to increased regulatory scrutiny or restrictions, which may require us to incur additional compliance and reporting expenses and adversely affect our business.

### Regulation of Swaps and Derivatives

The SEC, the Internal Revenue Service (“IRS”) and the Commodity Futures Trading Commission (“CFTC”) each continue to review the use of futures, swaps and other derivatives. Such reviews could result in regulations that further limit the use of such products by mutual funds. If adopted, these limitations could require us to change certain mutual fund business practices or to register additional entities with the CFTC, which could result in additional costs and/or restrictions. In December 2015, the SEC proposed a new rule governing the use of derivatives and other financial commitment transactions by investment companies that, if enacted, would represent a fundamental change in the nature of the SEC's regulations governing the use of derivatives and other financial commitment transactions by investment companies. While not on the SEC's current agenda for finalization, this proposal has the potential to require us to change or restrict certain investment strategies or practices and incur additional costs.

We also report certain information about several of our private funds to the SEC and certain information to the CFTC, under systemic risk reporting requirements adopted by both agencies. These reporting obligations have required, and will continue to require, investments in people and systems to assure timely and accurate reporting. The rules and regulations applicable to offshore funds, accounts and counterparties will require us to build and implement new compliance monitoring procedures to address the enhanced level of oversight to which we will be subject. These rule changes also introduce new requirements for centrally clearing certain swap, and eventually security-based swap, transactions and for executing certain swap, and eventually security-based swap, transactions on or through CFTC or SEC-registered trading venues. Jurisdictions outside the United States in which we operate also have adopted and implemented, or are in the process of considering, adopting or implementing more pervasive regulation of many elements of the financial services industry, which could further impact us and the broader markets. This includes the implementation of mandated central clearing of

## Table of Contents

swaps in the European Union (“EU”) and the implementation of trade reporting, documentation, central clearing and other requirements in various jurisdictions globally.

### SEC’s Proposals to Enhance Protections for Retail Investors

In April 2018, the SEC issued several proposals designed to enhance protections for retail investors in their relationships with financial professionals, including broker-dealers and investment advisers, with respect to both retirement and non-retirement accounts. The issuance of the SEC’s proposals followed a decision handed down in March 2018 by the U.S. Fifth Circuit Court of Appeals invalidating the U.S. Department of Labor’s “fiduciary rule” and related prohibited transaction class exemptions that had taken effect in June 2017. The most significant of the SEC’s proposals is a proposed “best interest” standard of conduct for broker-dealers and their representatives that would enhance the current “suitability” standard to which broker-dealers are subject by imposing an explicit care obligation and additional disclosure and conflict of interest mitigation or elimination requirements on broker-dealers that make securities recommendations to retail investors. The SEC’s proposed “best interest” standard contains certain elements that are comparable to some of the core principles that were reflected in the Department of Labor’s fiduciary rule and related exemptions. In addition to the proposed “best interest” standard for broker-dealers, the SEC has proposed an “interpretation” highlighting the fiduciary duties owed to clients by financial professionals who serve in an investment advisory capacity with respect to client accounts. We and our asset managers may be adversely impacted by the SEC’s regulatory initiatives in the retail investment space to the extent that they lead to changes in investment preferences on the part of financial intermediaries and investors and increased pressure on product fees and expenses.

### Alternative Investment Fund Managers Directive

Our European business is impacted by the EU Alternative Investment Fund Managers Directive (“AIFMD”), which became effective on July 21, 2011. The AIFMD regulates managers of, and service providers to, a broad range of alternative investment funds (“AIFs”) domiciled within and (depending on the precise circumstances) outside the EU. The AIFMD also regulates the marketing of all AIFs inside the European Economic Area (“EEA”). The AIFMD is being implemented in stages, which run through 2018. Compliance with the AIFMD’s requirements restrict alternative investment fund marketing and impose additional compliance and disclosure obligations regarding remuneration, capital requirements, leverage, valuation, stakes in EU companies, depositaries, the domicile of custodians and liquidity management on us. We have incurred, and expect to continue to incur, additional expenses related to satisfying these new compliance and disclosure obligations and the associated risk management and reporting requirements.

### MiFID II

We are subject to numerous regulatory reform initiatives in Europe. The United Kingdom and other European jurisdictions in which we operate have implemented through national legislation the Markets in Financial Instruments Directive (“MiFID”), which focused primarily on equities, to encourage trading across all asset classes to migrate onto open and transparent markets. MiFID II, which came into effect in January 2018, builds upon many of the initiatives introduced through MiFID. MiFID II has significant and wide-ranging impacts on EU securities and derivatives markets, including (i) enhanced investor protection and governance standards, (ii) prescriptive rules regarding the ability of asset management firms to receive and pay for investment research relating to all asset classes, (iii) rules on the identification and monitoring of target markets for MiFID financial instruments by MiFID investment firms who manufacture and/or distribute such instruments, (iv) enhanced regulation of algorithmic trading, (v) the movement of trading in certain shares and derivatives on to regulated execution venues, (vi) the extension of pre- and post-trade transparency requirements to wider categories of financial instruments, (vii) restrictions on the use of so-called dark pool trading, (viii) the creation of a new type of trading venue called the Organized Trading Facility for non-equity financial instruments, (ix) new commodity derivative position limits and reporting requirements, (x) a move away

from vertical silos in execution, clearing and settlement, (xi) an enhanced role for the European Securities and Markets Authority (“ESMA”) in supervising EU securities and derivatives markets and (xii) new requirements regarding non-EU investment firms’ access to EU financial market.

## Table of Contents

The United Kingdom has implemented rules regarding retail distribution review (the “RDR”) aimed at enhancing consumer protections, overhauling mutual fund fee structures and increasing professionalism in the retail investment sector. In order to achieve this, RDR requires advisory firms to explicitly disclose and separately charge clients for their services and clearly describe their services as either independent or restricted. It also requires individual advisers to adhere to consistent professional standards, including a code of ethics. Similarly, MiFID II contains a ban on certain advisers recovering commissions and other nonmonetary benefits from fund managers. These rules, if implemented, may lead to changes to the fees and commissions we are able to charge to our clients, as well as to our client servicing and distribution models.

### Undertakings for Collective Investment in Transferable Securities

The EU has adopted directives on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (“UCITS”) with respect to depositary functions, remuneration policies and sanctions. UCITS V, which came into effect in March 2016 with further measures implemented in October 2016, seeks to align the depositary regime, remuneration rules and sanctioning powers of regulators under UCITS with the requirements of the AIFMD. In addition, ESMA guidelines include rules relating to collateral management requirements for UCITS funds concerning collateral received in the context of derivatives using Efficient Portfolio Management (“EPM”) techniques (including securities lending) and over-the-counter derivative transactions. These rules required us to make a series of changes to collateral management arrangements applicable to the EPM of UCITS fund ranges and cause us to incur additional expenses associated with risk management and reporting requirements.

### Revised EU Capital Requirements

EU regulators are considering how to design an appropriate capital regime for non-systemically important investment firms as the current regime is based upon banking requirements and has not been materially modified for asset managers. In December 2017, the European Commission published a legislative proposal addressed to the European Parliament and Council for a new Directive and new Regulation on prudential requirements for MiFID investment firms. The new legislative package is currently expected to come into effect in 2020 following agreement between the European Council and Parliament. Once implemented, any new requirements could result in significant changes to the methodology used to determine the amount of regulatory capital that we are required to hold in the EU.

### Revised Retail Consumer Disclosure Requirements

EU legislators have introduced a new “Key Information Document” (“KID”), which is applicable where a retail consumer is sold Packaged Retail and Insurance-based Investment Products (“PRIIPs”) and which came into effect in January 2018. The KID must include specific information on costs, risks and performance. We are required to produce a KID for each fund in scope, as well as to make information available to distribution partners who sell these funds in the EU.

### British Exit from the European Union

The United Kingdom (“U.K.”) held a referendum in June 2016 in which voters approved an exit from the EU (“Brexit”), which resulted in significant volatility in several international markets. On March 29, 2017, the U.K. delivered notice under Article 50 of the Lisbon Treaty of its intent to leave the EU, beginning a two-year negotiation period for the U.K. and the 27 remaining members of the EU to reach agreement on the terms of the exit. On March 23, 2018, the UK and the EU leaders endorsed a 21-month transition period beginning on March 29, 2019 and ending on December 31, 2020 and adopted negotiating guidelines on the future EU-UK relationship. In general terms, this would preserve the current passporting regime within the EEA for UK fund and asset managers (such as Legg Mason) and products

(such as UCITS funds) for a transitional period. However, the terms of this transitional arrangement will not become legally binding unless by March 29, 2019, a formal withdrawal agreement between the UK and the EEA has been negotiated in full and agreed, ratified by the European Parliament and the European Council; and ratified by the UK (which is likely to require an Act of Parliament).

While the U.K. and the EU have agreed in principle to the terms of the transition period, the outcome of the negotiations between the U.K. and the EU and the long-term consequences of the resulting negotiations are uncertain. As a result of Brexit, we may incur additional costs due to having to locate more activities within the EU. There could also be changes to UK and EU immigration policies as a result of Brexit, which could lead to restrictions on the free movement

## Table of Contents

of investment and support staff between the UK and the EU. We will continue to monitor the potential impact of Brexit on our business operations and financial condition.

### Existing U.S. Regulation

The SEC is the federal agency charged with administration of the federal securities laws. Our U.S. asset managers are registered as investment advisers with the SEC, as are several of our international asset managers, and are also required to make notice filings in certain states. We and certain of our affiliates are also currently subject to regulation by the SEC, the Department of Labor (the “DOL”), the Federal Reserve, the Financial Industry Regulatory Authority (“FINRA”), the National Futures Association (“NFA”), the CFTC and other government agencies and regulatory bodies. Certain of our affiliates are also subject to various anti-terrorist financing, privacy, anti-money laundering regulations and economic sanctions laws and regulations established by various agencies.

The Investment Advisers Act of 1940 imposes numerous obligations on registered investment advisers such as certain of our asset managers, including recordkeeping, operational and marketing requirements, disclosure obligations and prohibitions on fraudulent activities. The Investment Company Act of 1940 imposes stringent governance, compliance, operational, disclosure and related obligations on registered investment companies and their investment advisers and distributors. The SEC is authorized to institute proceedings and impose sanctions for violations of the Investment Advisers Act of 1940 and the Investment Company Act of 1940, ranging from fines and censure to termination of an investment adviser’s registration. Investment advisers also are subject to certain state securities laws and regulations. Non-compliance with the Investment Advisers Act of 1940, the Investment Company Act of 1940 or other federal and state securities laws and regulations could result in investigations, sanctions, disgorgement, fines and reputational damage.

Our trading and investment activities for client accounts are also regulated under the Securities Exchange Act of 1934 (the “Exchange Act”), as well as the rules of various U.S. and non-U.S. securities exchanges and self-regulatory organizations, including laws governing trading on inside information, market manipulation and a broad number of technical requirements and market regulation policies in the United States and globally.

Our broker-dealer subsidiaries are subject to regulations that cover all aspects of the securities business. Much of the regulation of broker-dealers has been delegated to self-regulatory organizations, principally FINRA. These self-regulatory organizations have adopted extensive regulatory requirements relating to matters such as sales practices, compensation and disclosure, and conduct periodic examinations of member broker-dealers in accordance with rules they have adopted and amended from time to time, subject to approval by the SEC. The SEC, self-regulatory organizations and state securities commissions may conduct administrative proceedings that can result in censure, fine, suspension or expulsion of a broker-dealer, its officers or registered employees. These administrative proceedings, whether or not resulting in adverse findings, can require substantial expenditures and can have an adverse impact on the reputation or business of a broker-dealer. The principal purpose of regulation and discipline of broker-dealers is the protection of clients and the securities markets, rather than protection of creditors and stockholders of the regulated entity.

In addition, our asset managers also may be subject to the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), and related regulations, particularly insofar as they act as a “fiduciary” or “investment manager” under ERISA with respect to benefit plan clients. ERISA imposes duties on persons who are fiduciaries of ERISA plan clients, and ERISA and related provisions of the Internal Revenue Code prohibit certain transactions involving the assets of ERISA plan and Individual Retirement Account (“IRA”) clients and certain transactions by the fiduciaries (and several other related parties) to such clients. In April 2016, the Department of Labor, which administers ERISA, issued a final fiduciary rule expanding the circumstances in which advice furnished to retirement investors will be treated as fiduciary in nature as well as related prohibited transaction class exemptions. The substantive provisions of



the rule began to apply in June 2017. However, the applicability date of many conditions of the prohibited transaction exemptions accompanying the rule has been delayed until July 2019, while the DOL continues its re-examination of the rule and the prohibited transaction exemptions. The fiduciary rule and exemptions are focused on financial intermediaries who provide advice to institutional and retail retirement plan clients, including the third-party distributors who market and sell Legg Mason Funds and separately managed account program services, and mandate increased disclosure of financial intermediary compensation and mitigation of conflicts of interest. We and our asset managers may be adversely impacted by the fiduciary rule and exemptions to the extent that they lead to changes in financial intermediary and retirement plan investment preferences and increased pressure on product fees and expenses.

## Table of Contents

In October 2016, the SEC adopted a new rule (and amendments to existing rules) designed to promote effective liquidity risk management throughout the open-end fund industry, thereby reducing the risk that funds will be unable to meet redemption obligations and mitigating dilution of the interests of fund shareholders. The amendments also seek to enhance disclosure regarding fund liquidity and redemption practices. New rule 22e-4 will require each registered open-end fund, including open-end ETFs (but not including money market funds), to establish a liquidity risk management program. The Commission also adopted amendments to existing rule 22c-1 to permit a fund, under certain circumstances, to use “swing pricing,” the process of adjusting the NAV of a fund’s shares to effectively pass on the costs stemming from shareholder purchase or redemption activity to the shareholders associated with that activity. The funds are required to comply with rule 22e-4 beginning on December 1, 2018. The SEC delayed the effective date of the amendments that will permit funds to use swing pricing until November 2018 to provide funds, intermediaries and service providers time to work through operational issues. The potential impact of the new and amended rules on the funds and/or our business is unclear.

## Existing International Regulation

In our international business, we have fund management, asset management, broker-dealer and distribution subsidiaries domiciled in a number of jurisdictions, including Australia, Brazil, Japan, Hong Kong, Ireland, Singapore, Taiwan and the United Kingdom that are subject to extensive regulation under the laws of, and to supervision by, governmental authorities and regulatory agencies in each of these jurisdictions. Our international subsidiaries are also authorized or licensed to offer their products and services in several other countries around the world, and thus are subject to the laws of, and to supervision by, governmental authorities in these additional countries. In addition, a subsidiary of EnTrustPermal, for which we have entered into an agreement to sell, is a Bahamas bank regulated by the Central Bank of the Bahamas. In some instances, our international subsidiaries are also affected by U.S. laws and regulations that have extra-territorial application. Our offshore proprietary funds are subject to the laws and regulatory bodies of the jurisdictions in which they are domiciled and, for funds listed on exchanges, to the rules of the applicable exchanges. Certain of our funds domiciled in Ireland are also registered for public sale in several countries around the world and are subject to the laws of, and supervision by, the governmental authorities of those countries. All of these non-U.S. governmental authorities generally have broad supervisory and disciplinary powers, including, among others, the power to set minimum capital requirements, to temporarily or permanently revoke the authorization to carry on regulated business, to suspend registered employees, and to invoke censures and fines for both the regulated business and its registered employees.

The Financial Conduct Authority (“FCA”) currently regulates certain of our affiliates in the United Kingdom. Authorization by the FCA is required to conduct certain financial services related business in the United Kingdom under the Financial Services and Markets Act 2000. The FCA’s rules adopted under that Act govern capital resources requirements, senior management arrangements, conduct of business, interaction with clients, and systems and controls. The FCA monitors our compliance with its requirements through a combination of proactive engagement, event-driven and reactive supervision and thematic based reviews. Breaches of the FCA’s rules may result in a wide range of disciplinary actions.

In addition, certain of our affiliates must comply with the pan-European regulatory regime established by MiFID, which became effective on November 1, 2007 and regulates the provision of investment services and activities throughout the wider EEA. MiFID, the scope of which is being enhanced through MiFID II, sets out detailed requirements governing the organization and conduct of business of investment firms and regulated markets. It also includes pre- and post-trade transparency requirements for equity markets and extensive transaction reporting requirements.