Evolving Investment Management Regulation

Responding to closer scrutiny

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Contents

Foreword **2**

Executive summary **4**

Chapter 1
Intensive focus on culture and conduct of investment firms **6**

Chapter 2
Costs and charges: regulatory prescription **16**

Chapter 3
Turning up the heat on product governance **24**

Chapter 4
New products, passports, markets **30**

Chapter 5
Technology — will regulators become robocops? **42**

Chapter 6
Rising cyber security threat prompts regulatory reaction **46**

Chapter 7
Systemic risk debate deepens **52**

EIMR abbreviations **59**

Acknowledgements **60**

Foreword

Investment managers are facing volatile capital markets, in which they must seek to achieve the best possible returns for their clients. The uncertain political and social environment in many parts of the world is causing nervousness among investors and adding to volatility. The slowing of economic growth in emerging markets and continuing low interest rates in developed economies are furthering that unease. And as fiscal authorities continue to home in on aggressive tax avoidance practices, the investment industry's role is being questioned.

At the same time, the investment management industry is at the vanguard of channeling finance to drive economic growth and to support saving by aging populations. Given the critical importance of the industry, it is coming under ever closer regulatory scrutiny. In addition to continuing questions about systemic risk, it is being challenged to justify and reduce its charges and to control other costs paid for by its clients. Long-standing arrangements between firms and intermediaries are being made transparent, and new regulation is requiring fundamental changes to firms' business models.

The industry's relationship with its regulators is intensifying. Regulators around the globe are getting closer to firms and investment funds, seeking to deepen their understanding of how investment management businesses operate and the potential risks to clients and the capital markets. This is giving rise to a steady stream of information requests from regulators and policy makers, adding to the operational challenges for firms as they implement the many new post-crisis rules.

The regulators' view is not only intensifying, but coalescing too. National and regional regulatory priorities, encouraged by the efforts of supranational bodies such as IOSCO[1], now look very similar in many parts of the world. The impact of greater information sharing and the widening and deepening of international policy debates is clearly seen. As well as being focused on similar issues, regulators are adopting similarly active approaches to supervision. In short, regulators are increasingly wearing the same suits.

This trend is set to continue as the global debate on investment management activities and systemic risk takes its course. Yet, at the same time, the role of the industry — bringing those with money to invest together with enterprises in need of funding — is in increasing demand, as government and bank funding remains constrained. The industry is benefitting from the opening of new capital markets and regulatory support for new types of investment products.

The investment pie is growing. Governments are rising to the challenge of encouraging their citizens to provide for their own retirement and to save in order to spend. New tax-incentivised savings accounts are being introduced or existing ones extended. Investment funds will likely be the underlying investment components for much of this new business, increasing monies managed by the industry and intensifying the search for investible assets.

Despite these positive factors, investment firms have the distinct sense of someone breathing down their necks. This is uncomfortable and at times frustrating, but firms need to respond constructively to this closer scrutiny. They need to engage in open and positive dialogue with regulators, be open to challenge, rectify misconceptions and highlight unintended consequences. Successful firms will be proactive and keep on the front foot. They will demonstrably act in their clients' best interests in all matters and, through positive actions, secure a larger slice of the growing investment pie.

Jeremy Anderson
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Executive summary

Around the globe, regulators are increasing their supervisory and monitoring resources, both generally and specifically in relation to investment management.

Regulators have in the past tended to limit themselves to broad, industry-wide issues. Since the financial crisis, however, they have become more prescriptive, focusing on investment managers' conduct and behavior. Now there are signs that many regulators are substantially intensifying their activities, delving ever deeper and involving themselves in the technical operations of investment firms' activity in order to detect and head off undesirable practice and to improve understanding of potential systemic risks.

To do this, regulators are getting closer to investment funds and investment firms' business models, in both the traditional and alternative arenas. Firms' culture is subject to increased ***challenge*** and, in a low interest rate environment, ***costs*** are under particular scrutiny. But there are also ***opportunities*** for the industry to increase assets under management.

There remains an intensive focus on ***culture and conduct*** issues, which center on acting fairly towards customers in general, and on incentives and remuneration in particular. Also, how firms govern their business operations and the way in which they conduct their relations with clients, suppliers, intermediaries and the companies in which they invest their clients' portfolios are regulatory priorities. Firms' anti-money laundering procedures and their governance of outsourcing arrangements are examples. New to the good conduct scene are environmental issues. Carbon disclosure regulations for investment firms are set to follow a legally-binding treaty on climate action.

Harmful conduct is a prominent risk to investor protection and the strong fee-driven culture of the financial industry is under particular scrutiny. The regulatory response is a global crack-down on commissions paid to distributors, although the approach differs across jurisdictions. Some are banning or limiting payments between product providers and distributors, while others are requiring greater disclosure. The most recent example is the **US**

Department of Labor's new fiduciary rule, which is being described as a game changer for the industry.

Costs and charges have emerged as a standalone global regulatory theme, for both institutional and retail investments. There is an increasingly granular approach to disclosure and an international focus on the calculation and management of fees and other costs. And an increasing number of regulators are now asking whether the *level* of fund management charges is reasonable. In some cases they are setting caps on charges. Others are encouraging simpler products with reduced costs.

The debate has widened to a *value for money* question, with regulators and commentators asking whether investors are getting a fair deal. For example, within **Europe**, "closet index tracking" is a hot topic and the current investigations could have significant reputational repercussions for the fund industry.

In many of the major fund centers, regulators are taking similar approaches to ***product governance and disclosure***. As regulators' knowledge and capabilities deepen, they are intensifying their investigations and enforcement activity. Across the world, policymakers have expressed concerns that investment products are mutating and are too complex for retail investors, who are often unable to understand the risk-reward profile of products.

Amid the current period of slow global growth, policymakers and regulators are aware of their responsibility for helping to encourage investment. This is leading to ***new products, new passports and new markets***. Capital markets continue steadily to open up in developing economies, new fund passports remain a key focus in **Asia**, private investment is being encouraged to fill the gaps left by reduced government spending, and new fund types and savings products are being introduced. There is further stimulus to long-term savings in many countries. And while crowdfunding continues to concern, and sometimes perplex, regulators, its rapid expansion has led them to seek to formulate an appropriate response, trying to strike a balance between investor protection and stimulating economic growth via funding for small companies.

Although the investment management industry has been relatively slow to adopt new ***technology***, it is catching up fast. This is positive for the industry but brings challenges, which have not gone unnoticed by regulators.

In particular, as robo, or automated, advice enters the mainstream within the retail and wealth segments in developed markets, regulators are considering whether they need to extend or clarify the regulatory perimeter to cover new digital distribution channels and, if so, how. Robo-advice is seen by advocates as a middle way between personal investment research and face-to-face advice, but there is concern that this could lead to small investors being offered less effective advice than wealthier investors.

Also, FinTech is becoming a major driver for innovation in the investment industry worldwide. Some regulators have seen this as an opportunity for businesses in their jurisdictions and have taken steps to promote the industry locally.

The increasing use of technology and proliferation of data has increased the options and levels of service for clients. Unfortunately, it has also increased the likelihood of their data, or even their assets, being stolen. As a result, ***cyber security*** is now a global agenda item for regulators, and is viewed as a key systemic threat, which should be thought of in a much broader context than just another information technology issue. The **US** has led the way on regulatory intervention and regulators around the globe are now taking action. There are recognized global standards, but there is not yet consistency in rule-making.

Meanwhile, the wider ***systemic risk and investment management*** debate continues. Regulators are now focusing on investment management activities and the way that open-ended investment funds, in particular, are managed. Various international bodies and agencies are contributing to the ongoing policy debate, which seems to remain polarized. While discussions between policy and rule makers continue, however, the industry is seeing an increased number of *ad hoc* data and information requests, especially in relation to investment funds.

Given the turbulence in financial markets and the sheer issuance of bonds in the period since the Financial Crisis, it is perhaps unsurprising that policymakers are paying particularly close attention to leverage and liquidity. There are also demands for greater stress testing of funds, and investment managers are required to play their full part in ensuring the integrity, transparency and stability of capital markets.

Key questions for CEOs

- **Are we open to challenge about our business model and activities?**
- **Are we engaged in constructive dialogue with the regulators?**
- **Is the culture of my firm focused throughout on the customer?**
- **Are we controlling the costs and charges borne by our customers?**
- **Are we on top of what is coming down the regulatory pipeline?**
- **Are we spotting the new opportunities arising from regulatory change?**

Chapter 1

Intensive focus on culture and conduct of investment firms

Regulatory priorities on culture and conduct issues tend to change according to prevailing political and social concerns. These currently center on acting fairly towards customers in general, and regarding incentives and remuneration in particular.

There also remains a strong focus on how firms govern their business operations and the way in which they conduct their relations with clients, suppliers, intermediaries and the companies in which they invest their clients' portfolios.

Global crack-down on commissions

In the IOSCO Risk Survey, a high number of respondents classified harmful conduct as a prominent risk to investor protection. Respondents to the survey noted the risk of harmful conduct related to the mis-selling of products, a culture of greed evidenced by excessive fees undermining the quality of retail financial products, and deficient disclosure of financial risks leading to investors making decisions on the basis of inaccurate information. A particularly problematic area is the strong fee-driven culture of the financial industry.

It is no wonder, therefore, that new regulation is taking shape that seeks to ensure that distributors of funds act in the best interests of the end-customer and that questions continue to be raised about whether commissions paid by manufacturers or out of products create unacceptable conflicts of interest.

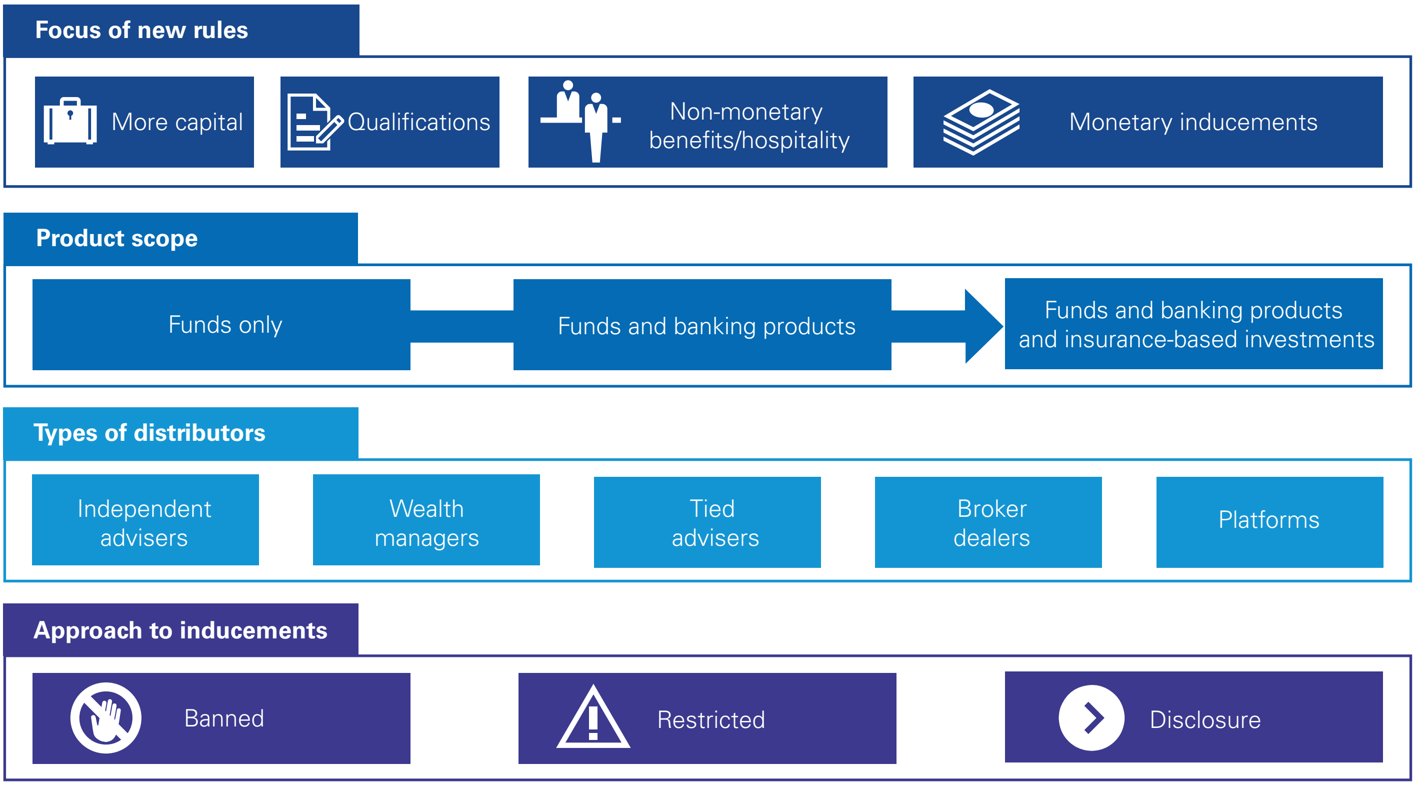
A focus on incentives started with the **UK**'s Retail Distribution Review (RDR), and the baton has since passed to countries across the globe.

In **Australia**, the debate has been conducted under the Future of Financial Advice (FoFA) banner and impacts all providers in the industry not just financial advisers. Legislation codifies a best interest duty on advice providers, including product manufacturers, and bans all conflicted remuneration, which is not limited to trailer fees paid directly to an adviser, although existing arrangements are grandfathered. The reform has required significant business model changes across all participants in the market.

The Australian industry has created a code of conduct, with the main target being advisors, whose details are listed on external websites, with customer ratings sought for each. The regulator has created a national register, which requires all advisers to be registered and details of their license and competency to be recorded to enable consumers to select and verify an adviser's details. The government is also proposing legislation that aims to raise the professional standards of advisers through a series of education requirements.

In **South Africa**, there is extensive financial regulatory reform with an overarching theme of consumer protection and treating customers fairly. The view is that, while South Africa has made progress on market conduct within the current legal framework, these initiatives can be significantly strengthened through structural change. Central to this change is a shift to a "Twin Peaks" model of financial regulation, a significant departure from South Africa's current regulatory framework.

Distribution: a regulatory pick 'n mix



South Africa currently has multiple regulatory authorities that regulate and supervise financial institutions on a sector-specific basis. The Twin Peaks model will make the switch to two primary regulators — a prudential regulator (the PA) and a new market conduct regulator (the FSCA). The FSCA will replace the SA FSB and will be responsible for the supervision of the conduct of business of all financial institutions and the integrity of the financial market.

Treating Customers Fairly (TCF) dovetails with the Twin Peaks initiative and it is envisaged that the TCF outcomes will be adopted by the FCSA as the blueprint for its regulatory mandate.

The SA FSB launched its own RDR in late 2014. The review foresees a "proactive and interventionist regulatory approach" by moving away from a purely rules-based compliance approach. The new approach interrogates and impacts structures with the aim of changing incentives, relationships and business models in the market. Ultimately, the RDR's 55 proposals seek to rekindle customers' confidence in the retail financial services market. They are expected to roll out in stages from 2016 to 2018.

In **Canada**, the Mutual Fund Fee Report (also known as the Brondesbury Report), was published in June 2015. It evaluates the extent to which fee-based versus commission-based compensation changes the nature of advice and impacts investment outcomes over the long term.

The Brondesbury Report concludes that while commission-based compensation is sufficiently problematic to justify the development of new compensation policies, there is insufficient evidence of better long-term outcomes under a fee-based model. The report cautions that while fee-based compensation is likely a better alternative, it is not a behaviorally-neutral form of compensation. Other forms of inducements that influence advice, such as bonuses or the potential for promotion at the dealer firm, and affiliation between a fund manager and a dealer firm, would likely persist under a fee-based model.

The report also finds that investor behavioral biases are an important factor in sub-optimal returns on investment and that these biases are unlikely to be overcome as a result of changing compensation schemes alone.

CSA[2] independent third-party research — "A Dissection of Mutual Fund Fees, Flows, and Performance" (the Cumming Report) — published in October 2015 evaluates the extent to which sales and trailing commissions influence fund sales. It finds that mutual funds that perform better attract more sales, but this effect is less strong when fund managers pay trailer commissions

[2] Canadian Securities Administrators

to dealers and distribute their mutual funds through affiliated dealers, because these have a negative effect on future outperformance.

The findings from these two reports will be key inputs to CSA deliberations on policy recommendations, due to be communicated in the first half of 2016.

Meanwhile, in the **US**, in June 2015 the SEC[3] launched a multi-year examination initiative, focusing on SEC-registered investment advisers and broker-dealers and the services they offer to investors with retirement accounts. It examines the reasonable basis for recommendations made to investors, conflicts of interest, supervision and compliance controls, and marketing and disclosure practices.

The SEC will also continue to examine investment advisers and dual-registered investment adviser/broker-dealers that offer retail investors a variety of fee arrangements (e.g. asset-based fees, hourly fees, wrap fees, commissions). It will focus on whether recommendations of account types are in the best interest of the retail investor at the inception of the arrangement and afterwards, including fees charged, services provided and disclosures made.

In addition, the SEC will examine investment advisers to municipalities and other government entities, focusing on pay-to-play and other key risk areas related to advisers to public pensions, including the identification of undisclosed gifts and entertainment.

In April 2016, the Department of Labor published its fiduciary rule, with a two-stage implementation in April 2017 and January 2018. The final rule is considerably less onerous than the draft. It clarifies that advertising, research reports, commentary and other marketing materials do not amount to advice. Under the "negative consent" provision, clients will have 30 days to object, otherwise the fee arrangements — commission-based or otherwise — will remain intact.

Similarly, investments made under prior recommendations could remain unchanged, provided the client is informed and does not request any adjustments. There is an exemption from "level fees" for advisors recommending clients roll assets from "401(k)" pension plans to Individual Retirement Accounts.

The various disclosures to clients are less than originally proposed and the requirement for advisers' remuneration to be disclosed on the firm's website has been retracted, in contrast to the approach in **Europe**. In **India**, too, the regulator is proposing disclosure of the remuneration of senior management of investment companies and the ratio of their remuneration to the lowest paid staff.

The **Brazilian** regulator requires the distributor to inform its clients of its total remuneration. Also, it has prohibited the rebating of administration fees by funds in which funds of funds are invested. A further instruction provides for enhancements in risk management and compliance for Brazilian investment managers. These rules are largely borrowed from the banking sector and similarly demand greater transparency. Taken together, the rules are expected to reduce the number of industry participants from its current level of 1,100 investment firms. Consolidation is likely to take place among lower volume, less efficient providers, as it has done in more evolved investment markets.

In **Mexico**, the regulator has targeted sales practices in an effort to standardize services to protect consumers. It is also looking at the regulation of independent investment advisers as part of sales practice regulation. Advisers were not previously regulated but now need to be registered and comply with all sales regulation.

Remuneration remains on the European agenda

IOSCO recommends that the remuneration of the management company be clearly and separately disclosed to other costs and charges within investment funds (see Chapter 2). In **Europe**, however, the debate is focused on the disclosure of remuneration levels of key individuals within the firms — including senior management and portfolio managers — and the firms' remuneration policies.

ESMA's new UCITS[4,5] remuneration guidelines are aligned with those under AIFMD[6], which were crafted for fiduciary businesses. However, many UCITS management companies are part of banking groups, which are subject to different guidelines. There is an ongoing difference of view between ESMA and EBA[7] on the application of the principle of "proportionality", with the European Commission now involved.

[3] Securities and Exchanges Commission
[4] European Securities and Markets Authority
[5] Undertakings for Collective Investments in Transferable Securities
[6] Alternative Investment Fund Managers Directive
[7] European Banking Authority

In addition, the Mexican regulator is pushing all pension plans to implement Global Investment Performance Standards in return for being allowed to invest in overseas securities. The regulatory move is in response to concerns that too much of Mexican pension fund wealth is concentrated on domestic stocks. Some of the larger funds have now hired global investment managers to invest in new asset classes.

Commissions in Europe — a patchwork

In **Europe**, MiFID II[8] imposes bans on commission paid to independent financial advisers and wealth managers. Any form of inducements paid to other parties must pass a "quality enhancement" test with regards to the service received by the client.

In the longer term, these moves will increase transparency and could have a substantial impact on the distribution landscape and the cost structure of the industry. However, in the first phase (pre-2020), fragmentation of the Single Market is likely. Some Member States will apply additional restrictions on inducements, there may be different national interpretations of the quality enhancement criteria that could lead to different "thresholds" being applied, and there might even be slightly different interpretations of "retail client". These differences will adversely impact cross border distribution.

Moreover, different distribution channels dominate across European markets, so the impact of MiFID II will be different in each. There is likely to be low impact in an already fee-based environment. In bank-dominated distribution markets, banks may initially retreat from their tentative steps to "open architecture", unless and until the quality enhancement test bites. Distributors will focus on a smaller number of products and product providers, so will not be focused on "whole of market", and thus avoid the ban.

Sweden is to introduce a wider ban on inducements for advisors to non-professional clients. This would prohibit banks from accepting payments from third party investment managers when they advise retail investors. These rules go further than MiFID II by extending the prohibition against accepting benefits from third parties to cover all advisory services, regardless of whether or not they are independent.

Conversely, the regulator in **Denmark** has decided not to impose a wider ban on inducements than under MiFID II but insists on greater disclosure. Although not required by law, a number of pension funds have declared that they will return any manufacturers' commissions to their funds, which may give them a reputational edge.

In **France**, the Autorité des Marchés Financiers (AMF) has said that rebates on subscription, redemption fees and management fees in funds of funds may be made only under certain conditions indicated in its recent guide.

The existing "adviser charging" (RDR) rules in the **UK** cover all advisers and execution-only platforms, but they do not yet cover discretionary investment managers with retail segregated mandates (i.e. wealth managers). The Financial Conduct Authority (FCA) has said that it will retain the super-equivalent ban on non-independent advisers and on platforms, and it will have to extend its rules to wealth managers.

Inducements: a fragmented EU distribution landscape

	Commissions	Non-monetary benefits	
Independent advice	Prohibited	Generally prohibited	Minor non-monetary benefits are permissible under certain circumstances
Portfolio management	Prohibited	Generally prohibited	Minor non-monetary benefits are permissible under certain circumstances
Non-independent advice (and other investment services) **Member States can impose stricter requirements**	Generally prohibited — only permissible if designed to enhance the quality of the relevant service to the client **UK, Netherlands: prohibited for retail clients**	Generally prohibited — only permissible if designed to enhance the quality of the relevant service to the client **UK: Review of hospitality and distributor training led to stricter guidance on what is permissible**	

[8] The revised Markets in Financial Instruments Directive

MiFID II will also impact the payment for investment research. Under current practice, **European** investment managers can obtain research from brokers and pay for it via commissions for executing trades. These execution and research costs are paid directly out of clients' portfolios. The new rules require investment research to be paid for either by the manager itself or out of a separate research payment account, which is subject to an agreed research budget and is funded by the client via an agreed charge. The manager must make disclosures to the client about payments out of the account and must regularly review the quality of research received.

This focus on commissions is closely linked to the current focus on costs and charges within funds and to new product governance requirements, which are discussed in Chapters 2 and 3.

Corporate governance and risk management remain priorities

In the **United Arab Emirates (UAE)**, a company law change that came into force in July 2015 has emphasized better corporate governance and disclosure for all companies, including investment firms. The stated objective of the new law is to continue the UAE's development into a global standard market and business environment, improve protection for shareholders and promote social responsibility. It is the first major overhaul of commercial company law since 1984.

In 2016, the **Malaysian** fund industry may see the launch of a newly revised Corporate Governance Code and the Islamic Fund and Wealth Management Blueprint.

Risk culture is evolving in **Australia**. A new prudential standard requires an institution regulated by the Australian Prudential Regulatory Authority (APRA) to have systems for identifying, measuring, evaluating, monitoring, reporting and controlling material risks. These systems, together with the structures, policies, processes and people supporting them, comprise an institution's risk management framework. The board is ultimately responsible for having a risk management framework that is appropriate to the size, business mix and complexity of the institution or group it heads. The risk management framework must also be consistent with the institution's strategic objectives and business plan. The regulator has not been more specific about the rules, meaning boards must develop their own standards.

In addition, in December 2015, Industry Super Australia and the Australian Institute of Superannuation Trustees announced a review into best practice governance, with the aim of creating a code of conduct for not-for-profit super funds.

Japan has seen the establishment of forums designed to monitor the success of the introduction of the corporate governance code and the stewardship code, aiming fully to embed the corporate governance reforms recently introduced. The Japanese regulator seeks to ensure fiduciary duty by supporting self-regulation efforts by the private sector. These efforts include verifying the independence of the management of affiliated distribution companies, and checking that customer centricity is embedded in operations and is consistent with rewards and incentives in financial institutions, from product development to sales, operations and investment management.

The **Irish** regulator is also looking afresh at the risk function, with a focus on governance arrangements, risk ownership and responsibility. This will be a high level review and will look closer at firms to see if there is a culture of identifying and proactively managing risks. The detail of this review is yet to be scoped. In addition, it is stepping up its focus on director time commitments in Irish authorized funds. This follows on from its 2015 work on sub-funds and whether directors are allocating appropriate additional time to reflect additional sub-funds being launched within an umbrella structure.

Meanwhile, in **Spain**, the regulator is concerned that funds should be professionally managed and

"self-managed" funds are coming under scrutiny. And the **Malaysian** regulator has set out 11 core principles for fund management companies covering culture, control and conflicts of interest.

Anti-money laundering rules continue to tighten

The constant drip-drip of anti-money laundering (AML) legal cases around the world ensure that this topic remains front and center for regulators. The irregularity of the cases means that investment firms are not yet fully on top of the issue.

In **Europe**, the fourth AML Directive came into force in June 2015, introducing stronger rules to combat money laundering and terrorism financing. The amendments, which should be in place by the end of 2017, focus on identifying terrorists through financial movement, preventing terrorists from moving assets, and disrupting the ability of terrorists to raise funds.

In addition, in October 2015, the ESAs launched a public consultation on two guidelines on AML and countering the financing of terrorism (CFT). The first set of guidelines relate to risk factors and simplified and enhanced due diligence, while the second set focus on risk-based supervision.

Ireland is one country that has taken the advent of the new Directive as a cue to act on AML issues. Following on-site inspections of funds and fund service providers, the Irish regulator identified a number of problems, including reliance on third parties to conduct due diligence and insufficient monitoring of investor transactions. The regulator also found examples of funds and fund service providers failing to provide identification documents. In particular, it notes "deficiencies" in the onboarding process for "politically exposed persons" — people who have been entrusted with a prominent public function. Also, sources of wealth are not being sufficiently identified and verified, the regulator said. It expects "all funds and fund service providers to carefully consider the issues raised".

The issue is being taken seriously in **Belgium**, too, where a review of AML measures in 2015 found numerous flaws. The review noted that the Belgian industry conducts a large part of its AML/CFT activities on the basis of risk. However, market participants' understanding of these risks was found to be fragmented and incomplete.

Singapore's Monetary Authority (MAS) revised some of its AML/CFT requirements in April 2015. The revisions are benchmarked against international best practices and the latest recommendations of the Financial Action Task Force, the global standard-setter. Key changes to Singapore's AML/CFT Notices include:

a. Requiring more comprehensive enterprise-wide AML/CFT risk assessments

b. Elaborating the requisite steps to identify and verify beneficial ownership of companies, LLPs and trusts

c. Introducing a new category of Politically Exposed Persons

d. Additional requirements for cross-border wire transfers exceeding SGD 1,500.

In November 2015, this was further amended to require investment firms to inquire if there exists any beneficial owner when performing customer due diligence on a customer that is a Singapore government entity or a foreign government entity. This was previously not required unless the investment firm had doubts about the veracity of the due diligence information.

In **Thailand**, the AML Act of October 2015 widened the scope of the securities and trading strategies that came under the statute. In the **UAE**, the enactment in 2014 of the new federal laws on AML and CFT brought its legal framework into closer alignment with international standards and expanded the supervisory and enforcement powers of the regulator bank to impose administrative sanctions and restrict the powers of senior management. Likewise, in **Bahrain**, the central bank has stepped up its AML checks, as well as focusing on data protection. It has pledged to take a tougher enforcement stance than in the past.

Jersey, together with the other Crown Dependencies, joined MONEYVAL's mutual evaluation and follow-up process in 2012. MONEYVAL is a monitoring body of the Council of Europe, and aims to ensure that members have effective systems to counter money laundering and terrorist financing and comply with the relevant international standards.

It is now responsible for assessing Jersey's compliance with relevant international standards. Its report on the "fourth-round" mutual evaluation of Jersey was agreed in 2015 and is due to be published mid-2016. The Jersey regulator, together with other Island agencies, plans to undertake a detailed review of the report and address the recommendations.

Know your clients and protect their assets

The **European** industry is implementing the many new rules in MiFID II, including on the protection of client assets and on internal governance and procedures. Also, the UCITS V Directive introduces detailed rules for depositaries, which are similar, but not identical, to those in AIFMD. In particular, the independence of the depositary from the manager must be clearly evidenced.

The **Irish** regulator has taken the initiative in a number of conduct and culture issues. It has launched a focused review called Client Asset Management Plans for Investment Firms. And in the **UK**, investment managers' compliance with the client asset rules has been a focus for several months.

In **Italy**, amendments in 2015 to the know-your-customer (KYC) rules by the central bank, the Banca d'Italia, will not now allow fund managers to rely on distributors for KYC assessments. This is causing fund managers considerable difficulties as they do not generally have direct access to underlying investors. The whole rationale of intermediation in investment management in Italy is therefore being brought into focus.

Outsourcing becomes a governance issue

Outsourcing is not necessarily associated with investment fund conduct, but the widespread use of outsourcing in the investment industry has encouraged regulators to consider related governance issues.

In **Jersey**, outsourcing is a natural source of regulatory focus since the island is a hub for administrators. Regulation has been strengthened to ensure that investment firms retain responsibility for outsourcing and maintain control and oversight.

In **Singapore**, MAS launched a consultation into outsourcing in late 2014 and has been weighing the responses since. The new rules are expected to be introduced in mid to late 2016. Singapore first issued its Guidelines on Outsourcing in 2004 to promote sound risk management practices for outsourcing arrangements of financial institutions, including

> "...examples of funds and fund service providers failing to provide identification documents."

> ...the need for an institution-wide, responsive and rigorous approach towards the management of outsourcing arrangements.

fund managers. As outsourcing arrangements have become more prevalent and complex over the years, MAS proposed revisions to these guidelines in order to raise the standards of institutions' risk management practices. The proposed new guidelines provide further guidance on sound practices relating to the responsibility of the board and senior management and to the monitoring and control of outsourcing arrangements. The changes, MAS says, emphasize the need for an institution-wide, responsive and rigorous approach towards the management of outsourcing arrangements.

Outsourcing, particularly custody, is also under the microscope in **Brazil**. A regulatory instruction, due to be issued in Spring 2016, requires custodians to provide documentation on controls for services provided. These controls must be passed by internal audit, then submitted to the management and board for approval. After that, independent auditors must audit the whole chain of controls and report on them.

Outsourcing is an area of focus in **Ireland** too. The regulator is carrying out inspections of service level agreements and operational arrangements with outsourcing providers for investment firms, fund managers and service providers. This is further development of the delegate oversight guidance that was published in Ireland in 2015.

And in the **UK**, the national trade association produced detailed guidance for its members after the regulator expressed concern about the extent to which fund managers are dependent on a small number of suppliers of fund administration services and that mangers' governance and oversight procedures were insufficient, in its view.

The environment emerges as a conduct issue

The regulation of conduct and culture can now be said to encompass Socially Responsible Investment (SRI) issues, too. While SRI, or ESG (Environmental, Social and Governance), issues are well-known in the investment industry, guidelines — rather than rules — predominate, and investment firms respond more to investors' wishes on, say, de-carbonization than to public policies.

Hitherto, firms have been encouraged to adhere to the Principles for Responsible Investment. KPMG, in partnership with the United Nations Global Compact, publishes a Sustainable Development Goals Industry Matrix,[9] which provides examples and relevant information on Sustainable Stock Exchanges. KPMG is also involved with the FSB's[10] Climate Disclosure Taskforce and the Green Finance Initiative.

However, rules are on their way. The 2015 United Nations Climate Change Conference held in Paris in December conference produced a legally-binding treaty on climate action, which contains emission reduction commitments from 187 countries starting in 2020. All countries will make commitments to reduce greenhouse gas emissions and manage the impacts of climate change. This will undoubtedly lead to a whole new set of regional and national carbon disclosure regulations for investment firms.

In fact, this is already happening in some countries. Following the conference, **French** law was modified to require more specific disclosure in the management report of French entities, including investment funds. These additional disclosures include information, or a reference to where this information

[9] https://assets.kpmg.com/content/dam/kpmg/pdf/2015/09/sdg-financial-services.pdf
[10] Financial Stability Board

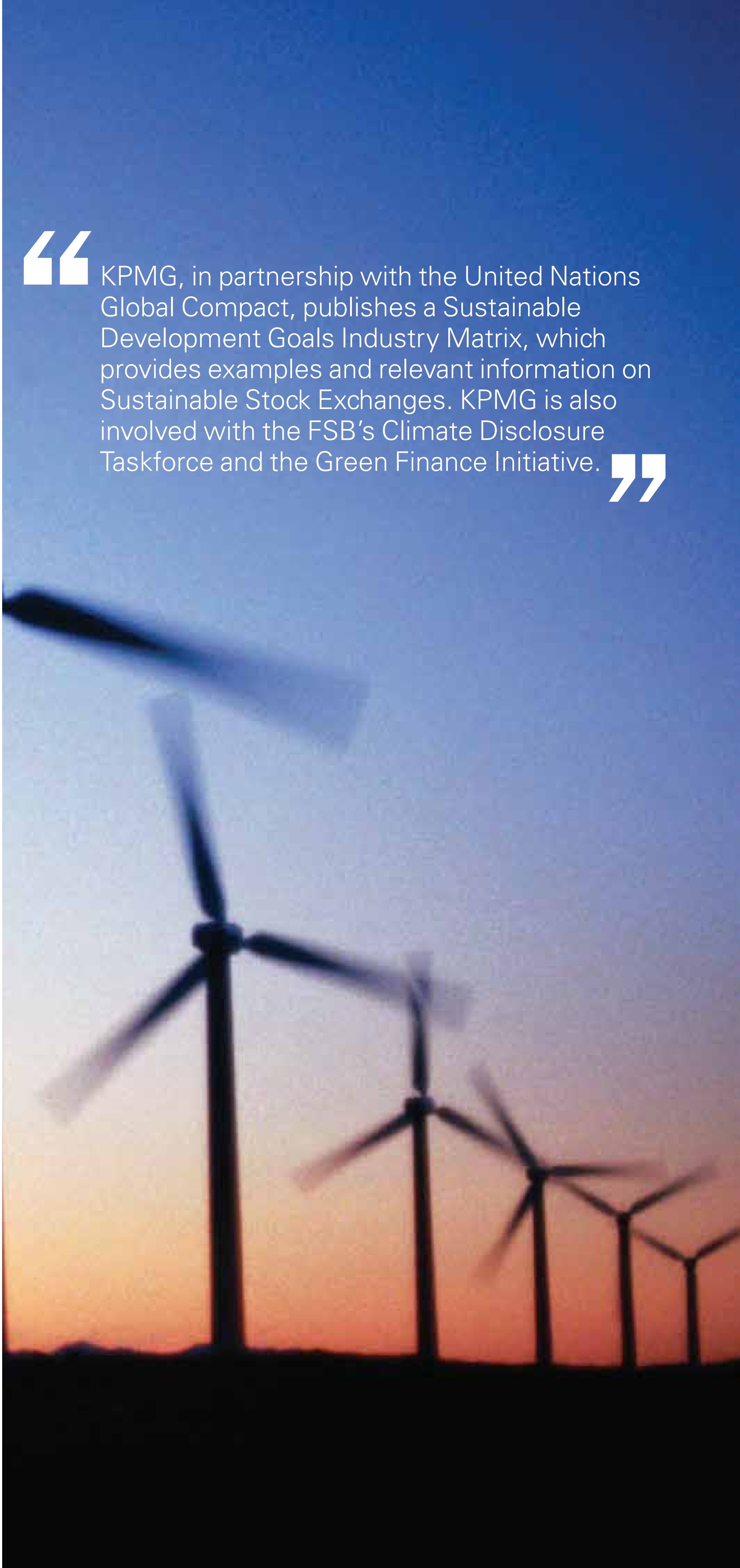
may be found (e.g. on a website), on the resources put in place to contribute to environmental improvements. The investment manager must take into account not only its direct activities, but the assets in which it invests its clients and their impact on the environment. The new rules are applicable from 31 December 2016.

Changes have also been made in **Thailand**. In March 2016, the Thai SEC, in co-operation with the Association of Investment Management Companies (AIMC), set out its Institutional Investor Code for promoting responsible investment. The code is an initiative to build confidence in the capital market in line with the objectives of the Thai SEC's Strategic Plan 2016–2018, which refers the promotion of best practice among institutional investors.

The Institutional Investor Code Working Group, which comprises representatives from the Thai SEC and the AIMC, is preparing the code, which will lay out policies and guidelines for corporate governance principles. These policies include the management of investment money, performance monitoring of target listed companies, preparation and disclosure of responsible investment policy, measures for handling conflicts of interest and ESG-based decision-making factors.

The Thai SEC expects the code to be incorporated by all investment management companies, first through a statement of intent to abide by the code, in order to encourage other institutional investors to adopt the code.

The CSA in **Canada** are currently exploring an explicit best interest standard for advisers and dealers, and in the **Netherlands** the authorities have invited the industry to submit suggestions to improve transparency, create appropriate regulation, and build up intermediary and advisory capacity on SRI.



"KPMG, in partnership with the United Nations Global Compact, publishes a Sustainable Development Goals Industry Matrix, which provides examples and relevant information on Sustainable Stock Exchanges. KPMG is also involved with the FSB's Climate Disclosure Taskforce and the Green Finance Initiative."

Chapter 2

Costs and charges: regulatory prescription

Regulators have in the past tended to limit themselves to broad, industry-wide issues. Since the financial crisis, however, they have become more prescriptive. Now there are signs that many regulators are substantially intensifying their activities, delving ever deeper and involving themselves in the technical operations of investment firms' activity in order to detect and head off undesirable practice.

For example, more and more regulators are not only seeking enhanced disclosure of costs and charges within products, but are becoming ever more prescriptive about how fees are calculated and managed, and are even focusing on the absolute level of fees levied by investment firms.

To do this, regulators are getting closer to investment funds and investment firms' business models, questioning whether investors are getting a fair deal.

Granular approach to costs and charges disclosure

Costs and charges have emerged as a standalone global regulatory theme, for both institutional and retail investments. Take **South Africa**, where the regulator believes it has taken a comprehensive and granular approach.

In February 2016, the South African regulator launched what is describes as a "meaningful cost comparison across investment products". Consumers and advisers will be able to compare charges and their impact on investment returns across most savings and investment products from October 2016, it says. All members of the Association for Savings and Investment South Africa (ASISA) are now required to adopt a standard on Effective Annual Cost (EAC). ASISA represents the majority of South Africa's investment managers, collective investment scheme management companies, linked investment service providers, multi-managers and life insurance companies. The EAC Standard will apply to the majority of products offered by these companies.

The concept is to create a standardized approach to cost disclosure that consumers and advisers can use to compare charges in a meaningful way, irrespective of whether the product is a collective investment fund, a living annuity, a retirement annuity or an endowment policy.

Previously, the South African industry had been applying the Total Expense Ratio (TER) method of cost disclosure. Although this method is used widely and is internationally accepted, it is now seen by the South African regulator as backward-looking since it does not take into account costs such as advice and initial fees. Providers must publish not only all investment management and advice charges, but a huge swathe of information ranging from loyalty bonuses and guarantees to smoothing or risk benefits and wrap fund charges.

Regulators in **Canada** are taking a similarly granular approach through Phase 2 of their Modernization of Investment Fund Product Regulation Project and the Client Relationship Model — Phase 2 project, which aim to ensure clients receive comprehensive and transparent information on the cost and performance of their investments. The Canadian regulators have a number of priorities in this respect:

— Simplified and fact-based reporting

— Cost of investment products

— Enhanced disclosure to investors of costs of investments and advice

— Mutual fund fees

— Continued focus on trailer and other fees

The Ontario Securities Commission (OSC), the biggest of the Canadian regional regulators, conducted a review in 2015 into the disclosure of fees and expenses in fund-of-funds structures, in both public and private funds. Based on preliminary responses, the OSC has identified errors in the calculation of the Management Expense Ratio (MER) and TER by a few fund managers of publicly-offered funds; in particular, the MERs and TERs did not include the expenses of the underlying funds. Guidance will be published when the review is completed.

EU disclosure of costs and charges — a moving picture

Different time frames

MiFID 2 Level 1

- Disclosure of *all* costs and charges of the investment service, including the cost of the financial instrument recommended or marketed and how the client may pay for it.
- The information shall be *aggregated* to allow the client to understand the overall cost and the *cummulative* effect on return of the investment.
- Payments to third parties can be made only if they satisfy certain conditions
- Disclosure to be at least annual.
- *UCITS and AIF[11] managers are not directly regulated by MiFID but the distribution of funds is, so managers must provide information for distributors.*

MiFID 2 Level 2

- Ex ante disclosure to be based on an *assumed investment amount* and on "*reasonable assumptions*" about costs and charges whose actual amounts are not known ex ante.
- All costs and charges to be aggregated and disclosed as a cash amount and as a percentage.
- For funds, requires assumptions about portfolio turnover (whether due to investment decisions or to activity in the fund's shares/units) and about investment return.
- Ex post disclosure of all actual costs and charges to be on a *personalised* basis.
- *ESMA defers to the Commission: how to deal with conflicting timing and substance of MiFID and PRIIP KID disclosures; and whether to require UCITS to make additional disclosures ahead of amendment of the KIID.*

PRIIP KID

- Includes 'appropriate' performance scenarios.
- Direct and indirect costs, both one-off and recurring, to be presented as summary indicators and *aggregated* to show the *compound effect* of the total costs, in monetary and percentage terms, on the investment.
- Detailed rules proposed by the ESAs, e.g. indirect costs include underlying transaction costs and bid-offer spreads.

Changes to the UCITS KIID?

In **Europe**, the MiFID II process has been rumbling on for years and is approaching its final format in terms of its approach to costs and charges, although the implementation date is expected to be extended by 12 months to January 2018.

All costs and charges down the supply chain, including those within the product itself, must be aggregated and disclosed *ex ante* at the point of sale and *ex post* at least annually. On an *ex ante* basis, this will require a number of costs and charges to be estimated. Incurred costs may be used as a proxy or the firm must make "reasonable estimations", adjusting its assumptions in the light of experience. Firms are also required to provide clients with an illustration showing the cumulative effect of costs on return.

ESMA noted the industry's concerns about overlaps and disconnect with the UCITS KIID,[12] which has been in place for four years or so, and the development of the PRIIP KID,[13] which is now running to a different timetable to MiFID II. It has deferred to the Commission to resolve how these inconsistencies are to be addressed. Also, it recommends that the Commission review the requirements of

[11] Alternative Investment Fund
[12] Key Investor Information Document
[13] Packaged Retail Investment and Insurance-based Products and Key Information Document

the UCITS KIID (which does not include disclosure of underlying transaction costs) and that in the meantime distributors should seek this information from the fund manager. Therefore, although UCITS are meant to be exempt from the PRIIP KID until end-2019, UCITS managers will in practice have to produce this information over and above the UCITS KIID. (See Chapter 3 for further information.)

Despite the lack of detailed rules or guidance on methodologies at this stage, especially in relation to assumptions used to calculate *ex ante* disclosures, it is essential that distributors and product manufacturers plan for implementation of these requirements. Data may need to be imported from different systems and departments within the firm; arrangements must be made to receive data from other firms involved in the supply chain and to pass information to the next firm in the chain; an internal process for agreeing necessary assumptions needs to be established; and the format of the disclosures needs to be agreed.

Costs and charges under the microscope across the globe

An international focus on the calculation and management of fees

The issue has been highlighted by IOSCO, which last reported on costs way back in 2004, but has been moved to revisit fees and expenses by recent shifts in investor expectations. It is debating and consulting on new or enhanced standards of good practice in a number of areas.

IOSCO suggests that expenses should be sub-divided into four broad categories:

1. Remuneration of the management company
2. Distribution costs
3. Other fund operating expenses (such as custody, fund accounting or administration costs for shareholder service providers)
4. Transaction costs associated with purchase and sale of portfolio assets (including securities lending and repo/reverse repo transactions).

Investors should have the appropriate information to evaluate the fees and expenses of a fund, IOSCO says. Cost disclosure is key, as is the proper management of conflicts of interest that might otherwise misalign the interests of investors and of the fund operator. Knowing where and how to obtain further information about fees and expenses is crucial for enabling investors to make fully-informed decisions. IOSCO observes in particular that sufficient and accurate information should be provided to investors who use electronic distribution channels, before they invest.

Increased investor awareness may exert downward pressure on fees, as investors learn to consider them in their investment decisions. At the same time, the rise of new technologies has created a growth of web-based portals and tools that are changing how investors receive and interact with fund information, including on fees and expenses. However, in some jurisdictions there are more complex distribution models, which may result in more elaborate fee-sharing or retrocession arrangements.

The consultation acknowledges that it may be difficult to estimate a fund's future transaction costs for a number of practical reasons. IOSCO notes that arguments for a single figure encompassing all charges and costs, including transaction costs, must be balanced by how the fund operator can manage the number and volume of portfolio transactions in line with the fee, and some costs cannot be accurately measured in advance. Also, the absolute level of such costs over a given period might not, by itself, be a good indicator of whether or not the fund had incurred costs in the interests of investors.

Among national regulators, the AMF in **France** has published clarifications about performance fees as well as the methods for calculating variable management fees for "ARIA" funds — which do not have to comply with all regulatory restrictions — such as alternative funds of funds and contractual collective schemes. The AMF's recent position paper does not impose an absolute limit on the amount of these fees.

In the **US**, the SEC plans to examine private fund advisers, maintaining a focus on fees and expenses and evaluating, among other things, the controls and disclosure associated with side-by-side management of performance-based and purely asset-based fee accounts.

Establishing exactly how management fees are calculated is a current priority of regulators in **Brazil**, too. The regulator has already established new criteria for performance fees in the wake of perceived unfairness to some fund shareholders.

Absolute level of fees under the microscope

To date, the regulatory dialogue on costs and charges has largely been focused on enhanced disclosure. However, an increasing number of regulators are now asking whether the *level* of fund management charges is reasonable. In some cases, they are setting caps on charges. Others are encouraging simpler products with reduced costs.

The absolute level of fees in pension schemes is being addressed in **Hong Kong**. The Mandatory Provident Fund Schemes Authority has announced a new core default fund, which will have a maximum fee cap of 0.75 percent, with the aim of encouraging the investment industry to produce more cost-effective funds.

In **Australia**, new MySuper legislation aims to push firms to create a range of easily comparable, relatively simple products, which are designed to focus competition on net costs and returns. APRA has further fostered competition by publishing fee tables.

The Australian Productivity Commission is reviewing default options in pension plans. It wants to see more and better choice for pension scheme members, again with the aim of increasing competition and reducing costs.

The Australian regulators are also putting pressure on smaller schemes to consolidate, by imposing increasing regulation around governance with which only larger schemes are able to deal. The retail-focused Australian regulator, the Securities & Investments Commission (ASIC) recently said: "A lack of strong price-based competition in the super system is leading to higher costs and sub-optimal outcomes for members. This along with other factors, such as low member engagement, may lead to Australians being financially under-prepared for retirement due to the inadequacy of their retirement income."

Ireland is adopting a similar approach. In a move that will put pressure on pension providers and investment managers to cut fees, it wants to cut the number of corporate retirement plans from 150,000 to just 100.

Widening of fees debate to "value for money"

Of course, any discussion of fee levels implicitly gives rise to a value-for-money debate. This debate is currently in full flow in the **UK**, where the FCA launched the Asset Management Market Study in November 2015. The study is based on initial findings in 2014 that many funds charge similar fees despite having widely differing cost structures. In particular:

— The difficulty investors have in getting value for money and in monitoring the performance of investment managers

— The role of investment consultants to pension funds and potential conflicts of interest from the provision of both advice and investment management services

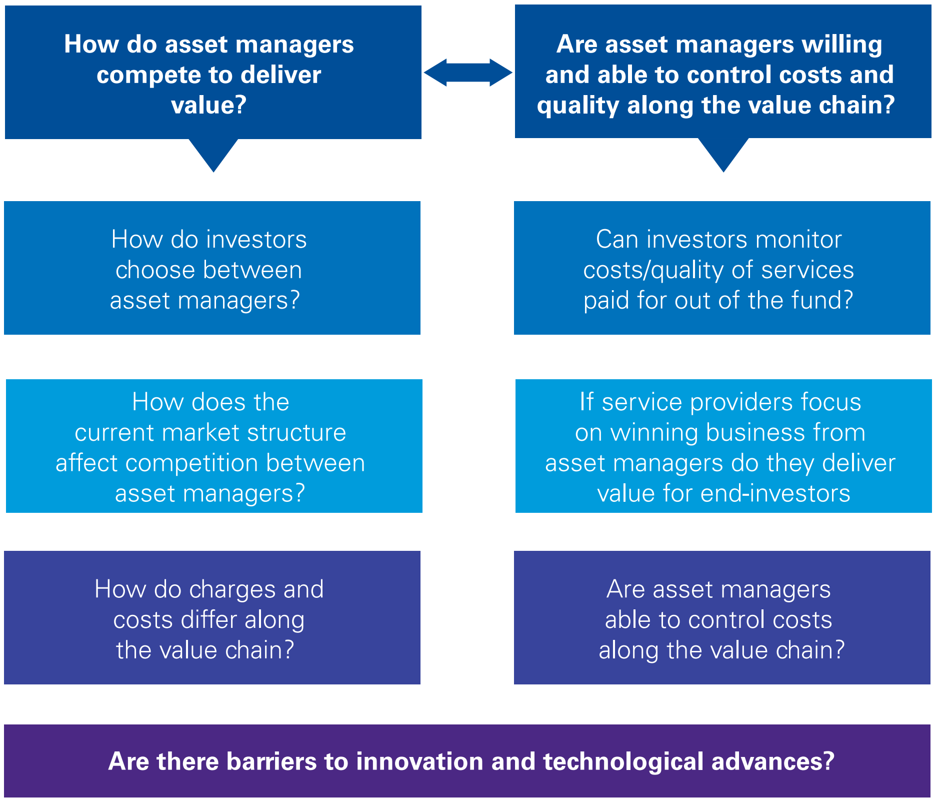
— The incentives for and ability of investment managers to control costs

— The bundling of ancillary services and the quality of some of the services provided.

The aim of the new study, says the FCA, is to understand whether competition is working effectively to enable investors to get value for money when purchasing investment management services. Given the size of the market and the long-term nature of investments, even a small improvement in the effectiveness of competition could be of substantial benefit for investors.

If the FCA finds that competition is not working well, it says it will intervene, introducing firm-specific remedies or enforcement action, publishing general guidance or proposing enhanced industry self-regulation. The aim is to publish an interim report in summer 2016 and a final report in early 2017.

Key questions in the UK Asset Management Study



Also in the UK, there are concerns that a large number of Local Government Pension Schemes (LGPS) may be wasting millions of pounds of taxpayer money on excessive fees to fund managers. The *Financial Times* reported a discrepancy in fees paid by the 89 LGPS. Its analysis of the funds' annual reports showed that high fees often did not translate into better performance and that funds paid very different fees for near identical performance.

The **Irish** Central Bank (the CBI), which oversees over 6,000 Irish-domiciled investment funds, including 3,725 mutual funds, is carrying out an analysis of the production costs of investment funds, in particular looking at TERs. This is to assess the reasonableness of fees charged by Irish-domiciled investment funds, in order to form a view as to whether these funds offer the investor value for money. The method employed by the regulator is a statistical desk-top review of the TER, which is a measure of the total cost of a fund to an investor, and typically includes the manager's annual charge as well as the cost of other services paid by the fund, such as custodian and auditor fees. The CBI, in the first instance, wants to identify outliers and will then decide how to proceed.

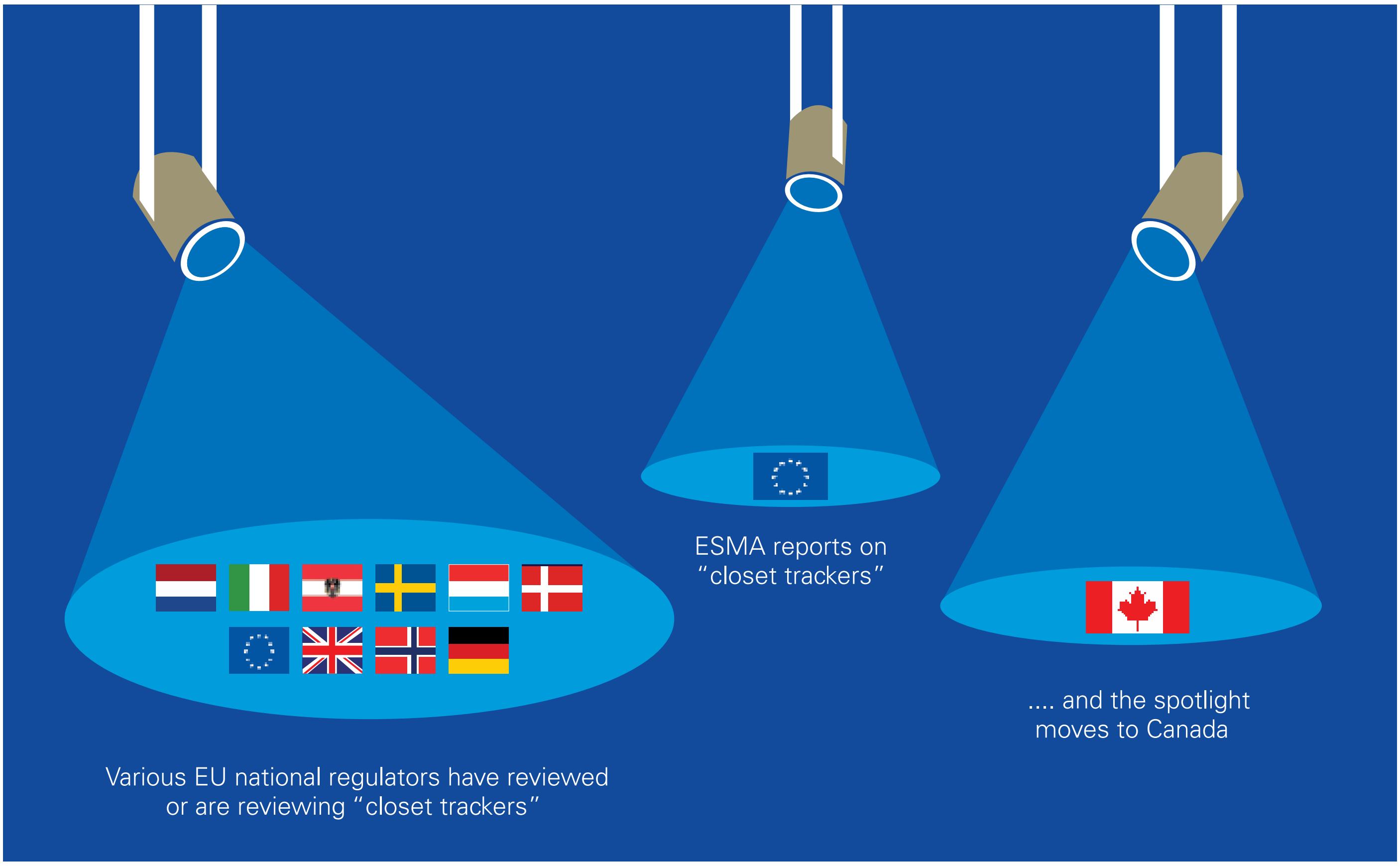
Index trackers are forced out of the closet

Closet index tracking is shaping up to be one of the hottest **European** regulatory topics of 2016. It mirrors the value-for-money debate, and could have significant reputational repercussions for the fund industry.

There have been informal discussions within the industry and in the media about the issue for a number of years, and ESMA announced in 2014 that it was examining the problem. But the issue heated up considerably in March 2015 when **Sweden** announced a crackdown on funds that charge high fees for strategies that merely track indices. The investigation into closet index huggers was the first example of a European government cracking down on the practice, which has been criticized by academics and consumer groups for misleading investors. However, the Swedish Courts have ruled that the names of the firms cannot be disclosed.

Per Bolund, Sweden's Deputy Finance Minister and Minister for Financial Markets and Consumer Affairs, said the investigation would focus on the differences in fees charged by a selection of comparable active and passive funds[14]. He said: "It is important you get what you pay for. When you start looking at funds that claim to be actively managed, it is sometimes hard to see why they charge higher fees than the available index funds."

EU spotlight on "closet trackers"



[14] Source: FTfm, March 2015

Once the investigation is complete, Sweden will consider introducing regulation requiring fund managers to give investors more information on the differences between active and passive funds. Mr Bolund encouraged other European governments to address the closet-tracking problem. He said: "The Swedish government is leading the way but I think many [other governments] will follow suit as this is an issue that needs to be raised on the European agenda."

Investigations have indeed been taken up by a number of other countries, including Sweden's neighbor, **Norway**. Norway's regulator in 2015 criticized a market-leading fund manager for selling a so-called closet tracker as an active strategy.

In **Italy**, CONSOB[15], the financial regulator, investigated the ten largest domestic investment management companies during 2015. In March 2016, it announced it had taken "remedial action" against a number of these companies, without naming them. It plans to carry out further investigation into closet tracking in 2016.

The **Danish** regulator reported on closet trackers in Spring 2016, disclosing that 56 out of 188 funds are "passive cabinets". This finding was based on analysis using "active share" and tracking error methodologies. Active share is a measure of the percentage of a fund's portfolio holdings that differs from the composition of its benchmark index.

Some firms were told to change their documentation and all those found to be closet trackers were publicly named, as is the regulatory custom in Denmark. As in many European countries, the Danish regulator can impose only token fines, and must refer the matter to the police and go through a civil or criminal legal process in order for larger penal fines to be imposed. The **UK's** FCA is unusual in being able to impose material fines.

In January 2016, the FCA said that closet indexing was on its agenda as part of its review of the UK's asset management sector and in April it announced that the documentation of almost one-third of 23 funds it reviewed did not adequately describe the funds' investment strategies.

In mid-February 2016, BaFin, the **German** regulator, which regulates Europe's fourth-largest national retail fund market by assets, widened the scope of an existing investigation. In the first phase, BaFin intends to gather quantitative data from German fund firms to identify which funds could be closet trackers. It will then carry out a qualitative assessment to "verify on a case-by-case basis whether those funds are in fact actively managed". BaFin has yet to outline the potential repercussions for fund companies found to be managing closet trackers. Regulators in **Luxembourg**, the **Netherlands** and **Austria** are also investigating the issue.

Industry participants should take seriously the allegations of closet indexing. Firms need to demonstrate that they are acting unambiguously in the interests of investors, including in the setting of the management fee charged and ensuring they do what it says on the tin.

This is not just a European regulatory priority. **Canada's** OSC has also launched a review of conventional mutual funds that disclose in their marketing materials that they pursue active management strategies. Among other data, the review considers a fund's "active share" to assess the extent of active management. The OSC has written to selected managers of Canadian equity funds to get a better understanding of their investment strategies and the reasons why the strategies resulted in investment portfolios that overlap significantly with the benchmark index. It has already received responses and is in the process of reviewing and requesting additional information.

ESMA releases findings on closet index tracking funds

ESMA reported on the issue in February 2016, and its viewpoint was revelatory. It analyzed a sample of 2,600 funds for the period between 2012 and 2014, and also reviewed investor disclosure documents to see how funds describe their management strategy. It used active share, tracking error and R-squared metrics to classify potential closet trackers. It found that between 5 percent and 15 percent of the EU's actively managed funds may potentially be closet index trackers. ESMA said its findings were "initial" and that it would play an "active role" in the co-ordination of further analysis at national level. In other words, the baton has been passed to the national regulators to investigate further.

ESMA further notes that managers should expect supervisory consequences where evidence for incorrect disclosures is proven. It also, though, suggests that investors should take some responsibility and make use of all available documentation when making an investment decision. It says "there may be value in assessing whether a fund has been able to achieve the objectives referred to in the fund documentation". It is notable that the UCITS KIID provides past performance information, but the new PRIIP KID will not (see Chapter 3).

Will ESMA take direct action? At the moment, it says it will not name and shame individual funds and expects national regulators to conduct their own investigations and, potentially, impose penalties on investment firms. Firms will want to be thoroughly prepared.

[15] Commissione Nazionale per le Società e la Borsa

Chapter 3

Turning up the heat on product governance

In many of the major fund centers, regulators are taking similar approaches to product governance and disclosure. A sharing of information — either formally or informally — is deepening regulatory knowledge of the different product types and helping to enhance regulators' capabilities. This has empowered regulators, who are now seeking to fine tune and intensify their product investigations and enforcement.

In **Europe**, the work of the European Supervisory Authorities (ESAs)[16] exemplifies the growing homogeneity in product policymaking. The ESAs are tasked with ensuring financial stability, strengthening and enhancing the EU supervisory framework, and creating a single EU rulebook. They aim to improve co-ordination between national supervisory authorities and raise standards of national supervision across the EU.

The ESAs' priorities for 2016 include consumer protection, looking in particular at PRIIPs. In an ambitious move, they will also target new product areas such as the use of "Big Data", seeking to encourage a greater emphasis by regulators on the co-ordination of their efforts across sectors.

[16] The ESAs are ESMA, EBA and the European Insurance and Occupational Pensions Authority (EIOPA).

Product disclosures are being harmonized

The ESAs issued in short order three consultation papers on how to determine and display risk, performance scenarios and costs in the PRIIP KID. All types of PRIIPs are covered — funds, insurance-based investment products and banking products (structured deposits, structured products and special purpose vehicles (SPVs)).

Unlike the UCITS KIID, which discloses information on risk, performance and costs based on historical data and known future charges, the PRIIP KID disclosures are forward-looking. This requires assumptions to be made about future market returns, possible product performance and the expected volume of underlying transactions in the fund. The industry and consumer groups are concerned that the original intentions of the PRIIP KID are at risk of being lost amid technical debates. It is leading to disclosures that are based on assumptions on assumptions, rather than historic or known facts.

The discussion also highlights the highly differentiated nature of different types of PRIIPs and the risk that one of the key objectives will be missed: to provide accessible and readily understandable information to enable consumers to make comparisons between products of the same type and of different types.

The rules have been submitted to the European Commission for adoption, but additional guidance is to be issued. Given that the PRIIP KID must be implemented by January 2017, it is essential that firms start their internal processes now in order to stand any chance of having the KID designed and systems in place and tested by then. Given that guidance is still awaited, many are saying that this is an impossible deadline. Firms should also pay close attention to the rules in MiFID II on the disclosure of costs and charges, which are inter-related and being developed to a different timeframe (see Chapter 2).

In **Canada**, the CSA are working on a risk classification methodology for use in the Fund Facts and ETF (Exchange-Traded Fund) Facts documents. Currently, fund managers determine the risk rating of a conventional mutual fund using a risk classification methodology selected at their discretion. The proposed methodology aims to create a standardized risk classification methodology to ensure greater consistency and improved comparability. The 90-day comment period ended on 9 March 2016 and further guidance was due at the time of publishing.

In **India**, the regulator has sought to improve product labeling: all mutual funds must now display a pictorial meter — a "riskometer", which looks like a car's speedometer — and indicate the fund's risk level. This, the regulator said, will make it easier for the investor to compare funds. Before, funds were bucketed into only three categories, high, moderate and low, which provided a less granular indication of potential risk.

More active approach to product governance

MiFID II will have an impact on how funds are offered across **Europe**. The scope of the updated Directive represents a huge undertaking and shows intent by European policymakers to create a strong and comprehensive distribution framework.

MiFID II brings in for the first time at European level detailed product governance requirements for investment firms that manufacture or distribute financial instruments or structured deposits. The requirements will also impact UCITS and AIF (Alternative Investment Fund)

PRIIP KID: the questions you need to answer

"This document provides you with key information about this investment product. It is not marketing material. The information is required by law to help you understand the nature, risks, costs, potential gains and losses of this product and to help you compare it with other products."

Names of the product, the manufacturer and the regulator.
What is the product?
What are the risks and what could I get in return?
What happens if [the manufacturer] is unable to pay out?
What are the costs?
How long shall I hold it and can I take money out early?
How can I complain?
Other relevant information.

managers. Although they are not directly subject to MiFID II, distributors of funds are, and will have to seek information from fund managers about their product governance process and the intended target market of the funds.

Manufacturers must ensure that products are manufactured to meet the needs of an identified target market of end-clients, that their distribution strategy is compatible with the target market, that they take reasonable steps to ensure that the products are distributed to the identified target market (which requires a regular flow of data from distributors), and that they periodically review the identification of the target market.

The product governance requirements are wide-ranging and cover all aspects of the product design, change and monitoring process, including effective controls, stress testing, identification of the target market, appropriate product information, appropriately trained staff and so on. The Level 2 rules acknowledge that many products can be considered as suitable for the mass retail market. However, for more complicated, less mainstream products (which may include some AIFs), the target market has to be identified in more detail.

Many European countries that are not part of the EU are likely to adopt similar approaches to the regulation of product governance. In **Jersey**, for instance, the Financial Services Commission (FSC) conducted extensive industry analysis and stakeholder consultation in 2015 on whether Jersey should seek equivalence with MiFID II. The feedback broadly supported the proposal to seek equivalence, but found that considerable work is required to gain it, including the creation of new or amended primary legislation and substantial redrafting of one or more of the FSC's codes of practice.

Meanwhile, in **Switzerland**, the Financial Services Act is moving closer to completion. The Act, which is designed to improve client protection, includes substantial changes to the Swiss market that are similar to MiFID II. There is particular focus on training and professional development for fund distribution professionals and advisers. A potentially highly-charged parliamentary debate is due to be held in 2016 to decide how similar the Swiss regime will be to EU rules.

Australia is taking a similar line to Europe. ASIC was handed substantial new powers following the financial system inquiry in 2015 and now is starting to take a more active stance to products. It is seeking powers to intervene to modify or ban products that it considers do not have the intended market impact or are sold to the wrong investors. It is implicitly saying that responsibility for the product stretches from point of sale to its intended final use by the investor.

The similarity to ESMA's approach, it should be noted, may partly stem from the fact that the ASIC chairman also chairs IOSCO. This is a live example of the synergies that are developing between regulators.

Joined-up approach to tackling complex financial instruments

Across the world, policymakers have expressed concerns that investment products destined for retail investors are mutating and now carry hidden risks.

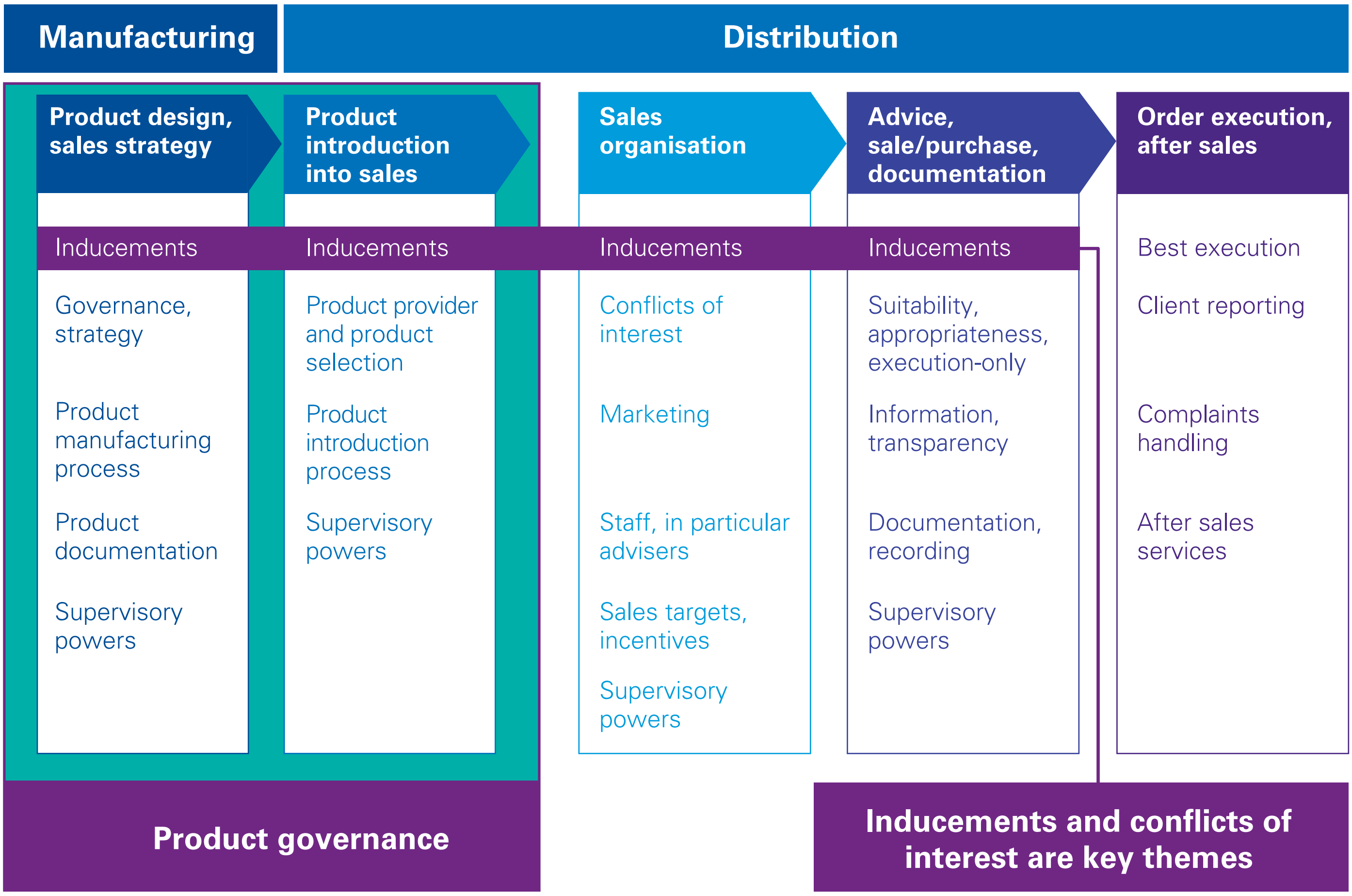
IOSCO has picked up on this as a priority area, opining that financial products (and their fee structures) are often complex. In many cases financial products include a derivative component, it says. In the harmful conduct cases under review, the issue appears to be that investors are unable to understand the risk-reward profile of the products, so are disappointed when products incur unexpected losses. Even when financial products were not complex, mis-selling occurred, with the recommendation of speculative stocks and products to investors who had a conservative risk profile.

IOSCO's concerns are echoed by regulators across the globe. In **Singapore**, for instance, the regulator plans to introduce a new complexity-risk ratings framework for investment products offered to retail investors. Products will be rated based on criteria such as the difficulty in understanding the risk-reward profile and the likelihood of losing the principle investment. It is proposed that such ratings be disclosed in product offering documents. Additionally, an opt-in regime for Accredited Investors (AI) is proposed. Under this regime, financial institutions serving eligible investors[17] will need to obtain clients' written confirmation to be classified as an AI and also to explain the consequent reduction in level of regulatory protection. First proposed in 2014, the complexity-risk ratings framework has been subject to a long consultation and is yet to be issued in final form.

In **Ireland**, there is currently a review of the use of financial indices as eligible investments in UCITS. Indices have grown in complexity and the CBI wants to ensure that UCITS' investments based on indices are appropriate and that funds are not exposed to assets they would otherwise be prevented from investing in under UCITS rules.

Meanwhile, across **Europe** as a whole, ESMA has developed guidelines under MiFID II to assess whether financial instruments are complex. If an instrument is deemed complex, then an appropriateness test must be applied, which requires firms to ensure that the client possesses the knowledge and experience to understand the investment and the associated risks. If the firm believes the client does not have sufficient knowledge and

MiFID II: focus on the manufacture-distribution chain



[17] Eligible investor is defined as an investor who meets any of the criteria stipulated in the accredited investor definition.

experience but the client wishes to proceed with the transaction, the firm must warn them before proceeding.

And under its mandate to promote a European single rule book, ESMA is also delving into technical questions such as what may or may not be a share class of a UCITS, as opposed to a different sub-fund. On 6 April 2016, it issued a second consultation paper, with draft principles, which could put an end to the practice in some countries of allowing certain types of hedged share classes, for example.

In some jurisdictions, the emphasis is on increased enforcement of existing product rules to ensure that investors are treated fairly. In **Bahrain**, for instance, the central bank has signaled it will closely supervise investment entities to ensure they collect and report product data on a quarterly basis, and to ensure that staff in key positions, such as audit, compliance and finance, are approved by the central bank. The regulator has already refused to approve a number of individuals in the last 12 months.

Product regulation extends to funds for affluent investors

Consumer protection is increasingly extended to wealthier segments of society, too. In **Brazil**, for instance, there is currently a radical overhaul of the Fondo Investimenti Piemonte (FIP) scheme, which was created as a vehicle for private equity and venture capital funds, but is widely used by individuals for tax and succession planning.

The Securities and Exchange Commission of Brazil (CVM) issued two drafts for discussion in 2015, one focusing on operations of FIP products and one on accounting. Operationally, the main changes are that FIPs will be allowed to invest up to 20 percent of their committed capital outside Brazil. In addition, a new category of FIPs are allowed to invest up to 100 percent of their net asset value outside Brazil. New categories of FIPs have been created to invest in emerging market companies, technology, innovation and infrastructure. One category is even allowed to invest in companies without audited financial statements.

In addition, the relative roles of administrators and investment managers are starting to change. Whereas the administrator under FIPs has always been responsible for most of the fund's functions — hiring the investment manager, custodian, auditor, signing docs, responding to the CVM — under new rules, the investment manager will be allowed to sign contracts in the name of the fund.

In terms of accounting, FIPs will no longer have such flexibility in setting valuation criteria, as the CVM adopts International Financial Reporting Standards (IFRS) concepts. IFRS has already been applied to Brazilian real estate and credit funds. However, the requirement to monitor changes in valuations on a regular basis is causing concern among investment managers that the publication of too much commercially-sensitive information could pose a business risk. While the CVM has signaled unwillingness to back down on transparency, a compromise — such as a delay in publication — may be found. Rules will be implemented in 2017–2018.

Similarly, in **South Africa**, regulators are seeking to protect the mass affluent and high net worth investors as well as retail investors. To date, hedge funds have been largely unregulated, with only the conduct of hedge fund managers being regulated through the Financial Advisory and Intermediary Services Act.

The South African National Treasury and Financial Stability Board (SA FSB) have been working on a proposed framework to regulate hedge funds as a special collective investment scheme, to provide greater protection to investors, prevent systemic risk, promote market integrity and enhance transparency. In March 2015, a determination on the requirements for hedge funds was issued by the Registrar of Collective Investment Schemes and became effective in April 2015.

The determination establishes two categories of funds — Retail Hedge Funds and Qualified Investor Hedge Funds. The latter are less strictly regulated as the investor pool is limited to qualified investors — they must have demonstrable experience and knowledge of financial and business matters, and must invest at least ZAR1 million.

In **Canada**, the CSA continue to look at the distribution of exempt market products (i.e. products exempt from the prospectus-based distribution requirements), and at cost and performance reporting of products to clients. They are also trying to facilitate new investment products into the regulatory regime as part of the Investment Funds Modernization Project. In addition, some recent amendments codified aspects of ETFs that were otherwise subject to one-off exemptions. Finally, the CSA have proposed an alternative funds regulatory regime to help with the distribution of non-traditional fund products, such as hedge funds, that meet certain criteria (i.e. liquid alternatives).

“The CSA has proposed an alternative funds regulatory regime to help with the distribution of non-traditional fund products, such as hedge funds, that meet certain criteria (i.e. liquid alternatives).”

Chapter 4

New products, passports, markets

Regulators are aware, particularly amid the current period of slow global growth, of their responsibility for helping to encourage investment. While many of their pronouncements are viewed as restrictive, some of their measures are demonstrably positive for markets and open new channels for fund managers and their clients. We noted this trend in the 2015 Evolving Investment Management Regulation (EIMR)[18], and we have seen the trend strengthen over the last 12 months.

Capital markets continue steadily to open up in developing economies, new fund passports remain a key focus in Asia, private investment is being encouraged to fill the gaps left by reduced government spending, and new fund types and savings products are being introduced.

[18] Evolving Investment Management Regulation, KPMG International, June 2015

Foreign investment firms see improvements in market access

Asia will clearly be one of the main growth drivers of the investment management sector going forward. Yet few foreign investment managers have managed to make much headway in this diverse and continuously changing region. While the opportunity is alluring, many foreign players have struggled to make good on their Asia strategies. Some have been put off by the sheer complexity of the regulatory requirements. Those which are active in the region often find it difficult to break into adjacent markets due to regulatory barriers. The reality is that the region is made up of more than two dozen independent countries, each with their own regulatory bodies, growth rates and level of economic openness. Simply put, the reason regulation is so complex for those looking at Asia Pacific as one market is that it is not one market.

But recent regulatory changes to market structures have made the environment considerably easier to navigate.

In **China**, for example, the introduction of the Qualified Foreign Institutional Investor quota system has improved foreign access to the market. Meanwhile, the launch of the Shanghai-Hong Kong Stock Connect system has improved product development and is a welcome addition for foreign managers to the well-established quota system. Also, the Securities Law is being strengthened to provide greater protection to investors.

Chinese pension funds are steadily increasing their investments overseas and are contracting third-party investment managers to widen their investment expertise. This is opening up opportunities for foreign investment managers.

In **Singapore**, MAS and the Accounting and Corporate Regulatory Authority (ACRA) announced in March 2016 that they were planning to introduce open-ended investment companies (OEICs). Senior Minister of State for Finance, Indranee Rajah, said the OEIC framework, which should be in place in 2017, would create a more efficient fund administration structure and encourage more investment managers to house their funds in Singapore. Further to attract foreign investment management firms, MAS is expected to enhance its External Fund Manager Program and offer stronger incentives to fund managers which are committed to deepening their presence in Singapore.

Mr. Nicholas Hadow, chairman of the Singapore industry body, commented, "Inevitably it has to do with our competitive situation. We wish to remain at the forefront of the fund management industry. We should be a competitor to places like Luxembourg, and indeed why should not Singapore be the Asian Luxembourg."

However, changes to market structures are not always positive for foreign managers: indeed, in some cases, regulators have started to shift the balance towards quasi-protectionist measures. **Taiwan's** recent regulation for offshore managers, for example, requires investment managers to keep at least USD161 million in assets under management (AuM) within Taiwan.

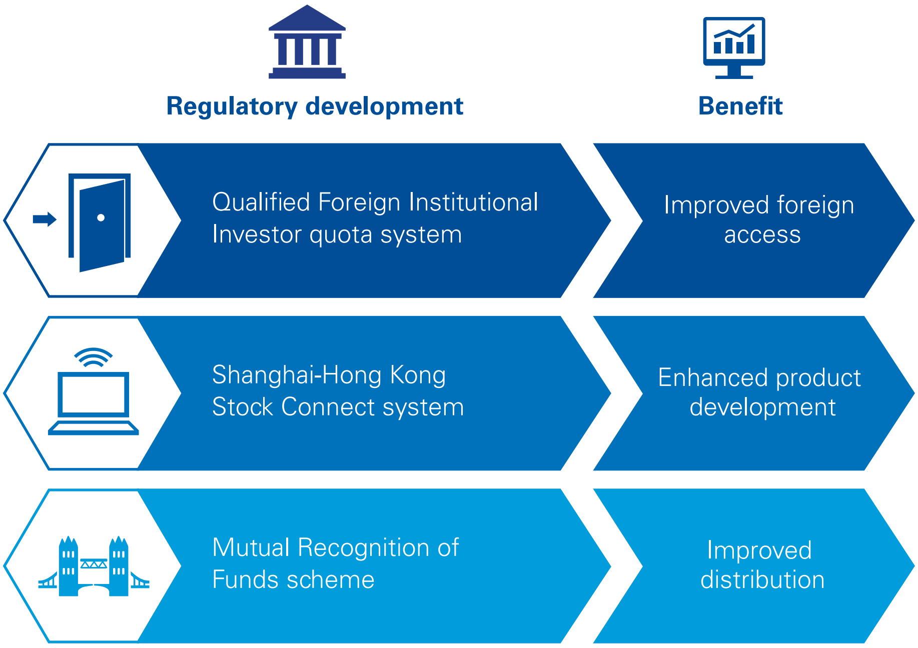
The rise of fund passports

The first regional funds passport, UCITS, has existed in Europe for 30 years now and was supplemented by the AIFMD in 2014. It has taken a long time for the rest of the world to catch up with UCITS, but momentum is now firmly with the passporting bandwagon.

Asia is leading the way. For the more mature Asia-Pacific markets —

> Simply put, the reason regulation is so complex for those looking at Asia Pacific as one market is that it is not one market.

New market opportunities in China



Source: *Frontiers in Finance*, December 2015, KPMG International

Australia, Taiwan and Singapore in particular — changes in investment management regulation reflect a desire by governments and financial authorities to create a regional hub, performing a similar function as Luxembourg or Ireland do in Europe. And it is these markets that have been behind the creation of three new passport arrangements aimed at making it easier for foreign and local investment managers to break into the region.

While **Australia** was the first publicly to suggest a passport arrangement for Asia Pacific, the first solid steps came in the form of a bilateral agreement. The Hong Kong Securities and Futures Commission (SFC) and China Securities Regulatory Commission (CSRC) announcement in May 2015 brought into existence the Mainland-Hong Kong Mutual Recognition of Funds (MRF). This took the market by surprise because the implementation date of 1 July 2015 afforded market participants just a few weeks to prepare. Indeed, it was not until December 2015 that the SFC authorized the first batch of mainland funds for retail distribution.

The arrangement allows funds managed in one territory to be distributed in the other, subject to a quota system. Under MRF, qualified funds are authorized in accordance with mainland or **Hong Kong** laws and regulations, initially covering simple fund products. The types of products may be expanded as the scheme matures.

Funds are subject to a streamlined vetting process by the host regulator. Meanwhile, fund operations — dealing, valuation, audit and meetings — must comply with the laws and regulations of the home jurisdiction. In terms of investor protection — the SFC and the CSRC have strengthened regulatory co-operation and assistance and specified dispute resolution mechanisms.

To date, there has been more "southbound" activity than "northbound", with **Chinese** funds registered to be sold in Hong Kong. This reflects restrictions on northbound flows, to prevent Hong Kong investment firms setting up funds purely to be distributed in China and take advantage of the huge untapped market. Chinese funds, which tend to be larger, have far fewer opportunities to distribute into the Hong Kong market.

According to the SFC, at 18 December 2015 it had received over 30 applications from mainland funds (southbound), and the CSRC had received 17 applications from Hong Kong funds (northbound). By the end of December 2015, the SFC had authorized a total of 13 mainland funds.

At first glance, it may appear that mainland fund managers are more enthusiastic about MRF. However, there are about 100 Hong Kong-domiciled funds and some 850 mainland funds that are eligible to apply for MRF status. Therefore, *pro rata*, the Hong Kong fund managers' application rate is higher.

MRF coincides with moves by the Hong Kong regulator to make the jurisdiction friendlier to foreign funds. A 2015 regulation streamlined the authorization process and was well-received by investment firms, which have seen a sharp reduction in fund registration times. The SFC announced the new fund authorization process (the "Revamped Process") in October 2015. After a six-month pilot arrangement, refinements are being made before the Revamped Process is adopted as policy.

New fund applications are bifurcated into two streams — Standard Applications and Non-standard Applications — with a view to reducing the processing time without compromising investor protection. Before the Revamped Process, the SFC specified a six-month processing time.

Hong Kong is making considerable efforts to improve its investment regulation and sees MRF as a catalyst for much larger flows. For this reason, it has decided to focus its efforts on this and not to participate in either of the Asian passports that are currently in development. These are:

— The Asian Region Funds Passport (ARFP)

— The Association of South-east Asian Nations Collective Investment Scheme Framework (ASEAN Framework)

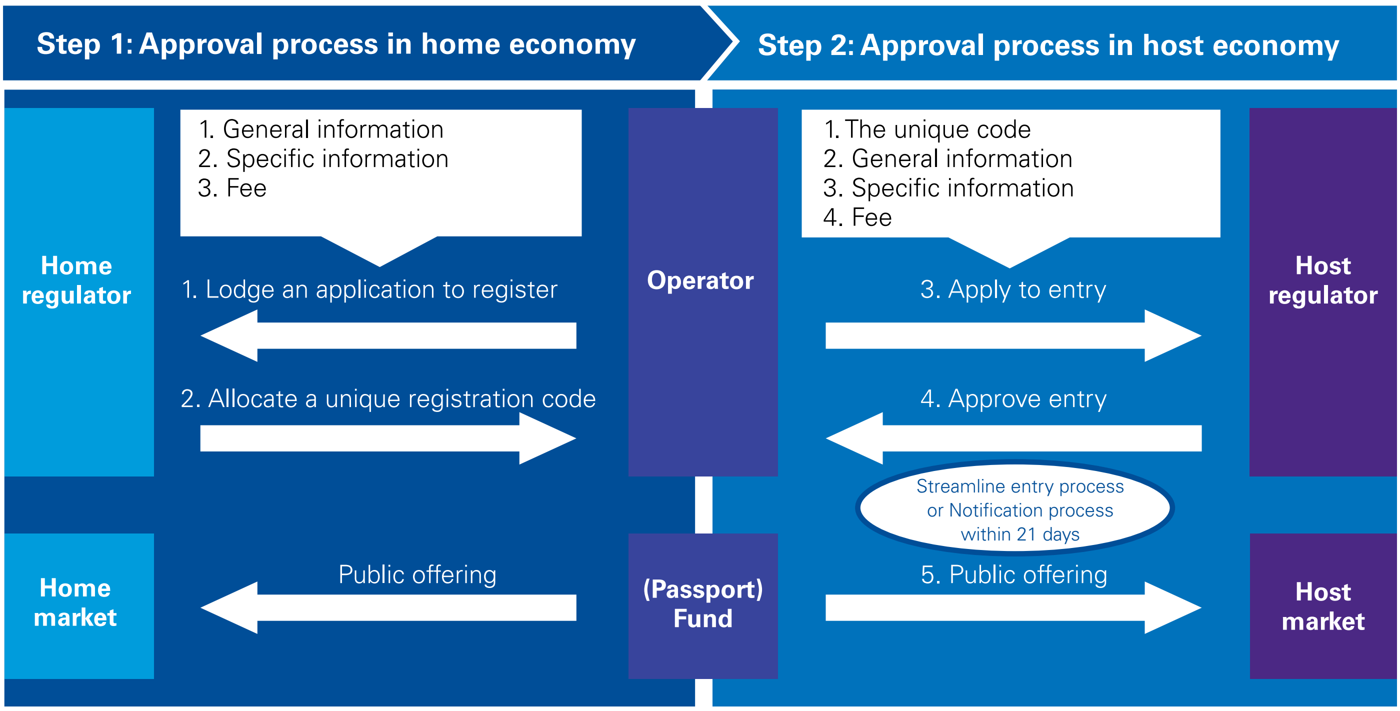
The ARFP was signed in 2013 but has yet to be implemented. **Australia, South Korea, New Zealand and Singapore** were the initial signatories, with the **Philippines and Thailand** joining more recently.

Progress to formalize the agreement has been slow and, while a Statement of Understanding was signed at the Asian-Pacific Economic Co-operation Conference in September 2015, negotiations have been bogged down. Singapore left the group in late 2015, saying it would consider returning only when a number of tax considerations are clarified. The South Korean government meanwhile says deliberations on changes to local laws and regulations may continue until early 2017.

The biggest fillip to the passport came in September 2015 when **Japan**, which

ARFP approval process for cross-border offering of a Passport Fund

The biggest advantage of a Passport Fund is the streamlined entry process to the host market. The process used to take, in general, several months.



has one of the world's largest fund management industries, committed to participate in the ARFP. The Japanese regulator stated that to respond to the challenge, it will be necessary to allow more flexible regulations, particularly in relation to regulatory approvals allowing rapid fund establishment. Self-regulatory authorities and industry bodies, as well as financial authorities, will need to support the ARFP scheme and be responsive through regulations suited to changing market needs. These include product design, establishment of sales channels, responsiveness to investor needs, IT developments such as management and sales of funds through mobile/web technologies, cross-border fund management, prime broker bookings, global custody services and integration of back office services etc.

Since Japan is essentially a self-contained market, a concept similar to UCITS may be perceived as interfering with Japan's sovereignty and questions are likely to be asked by industry participants prior to the ARFP's introduction.

The next step is for the participating members to sign a Memorandum of Co-operation sometime in 2016, after which they will have 12 months to implement the ARFP in their home jurisdiction.

The second passport arrangement came out of the formation of the ASEAN Economic Community, when securities markets regulators from **Singapore, Malaysia and Thailand** agreed to a cross-border offering of collective investment schemes. About ten funds have been put onto the new platform.

Of these, at the time of writing, six are from Singapore, managed by three separate management groups. Given the large number of investment managers in Singapore, the take-up rate cannot be said to be spectacular. Part of the reason for this is that larger fund houses tend to have already established a presence in each of the ASEAN countries. At the moment, the passport is more cumbersome to put in place in terms of processes and procedures compared with establishing a direct local presence.

Other countries are likely to join in time: these include **Laos and Indonesia**, which currently have fund management regimes that are not yet up to the required standard. In addition, some countries may end up positioning themselves at the nexus of more than one fund passport arrangement (as Singapore seems set to do).

Implications of the Asian regional passports

Source: KPMG International 2015

Impact of the fund passports on investment firms

The benefits of the Asian passport systems should be significant. The arrangements could propel the growth of an end-to-end investment management industry in participating countries, creating locally manufactured products and helping to recycle savings back into local markets. The passport schemes should also help participating countries to create a more diversified, investor-focused and competitive investment environment.

For local investment managers, the passport schemes help to improve access to new customers and allow for the development of more sophisticated products with a higher ceiling on AuM growth. For established managers outside Asia, the creation of these passports offers the opportunity to access a huge retail investor base through a single regional office and with a more straightforward marketing process.

Meanwhile, the EU remains closed to non-EU alternative funds

The AIFMD presumes that the passports would be extended to non-EU AIF managers and non-EU AIFs from July 2015. In its advice to the European Commission at that time, ESMA proposed this be done on a country-by-country basis but provided a positive opinion on only three jurisdictions — **Jersey, Guernsey and Switzerland.**

The Commission agreed that a country-by-country approach was appropriate, but apparently was reticent to extend the passport to only three jurisdictions in the first wave. It therefore wrote to ESMA requesting that by 30 June 2016 it:

— Complete its review of the **US**, **Hong Kong** and **Singapore**.

— Review six other countries — **Japan, Canada, Isle of Man, Cayman Islands, Bermuda and Australia**.

— Provide a more detailed assessment of the capacity of supervisory authorities and their track record in ensuring effective enforcement, including for the countries considered in the first wave.

— Provide a preliminary assessment of the expected inflow of funds by type and size into the EU from relevant third countries.

On receipt of positive advice and opinion from ESMA, the Commission has up to three months to adopt rules that will specify the date from which the AIFMD passport becomes available to managers and AIFs in those jurisdictions. The European Parliament and the Council then have up to three months to object to those rules. This would point to the passport being extended to certain countries at the earliest by late autumn 2016. From that date, the passport and, where available, national private placement regimes will co-exist for a period, originally envisaged to end in 2019.

Development of Middle East investment hubs

The **Middle East** has not tried to replicate structures in Europe and Asia by developing a regional passport. Instead, a number of Middle Eastern countries have sought to create investment hubs that are attractive to both domestic and foreign investment firms. The most mature of these is the **Dubai** International Financial Centre (DIFC). With regulations based on English law, the DIFC, a financial free zone, has had considerable success. Active financial services registrations at the DIFC rose by 13 percent in 2015 compared with the previous year.[19] Dubai has clarified its regulations in the last two years to make the free zone more attractive, providing more clarity on the processes for setting up a fund. It has also updated its rules on sukuk issuance.

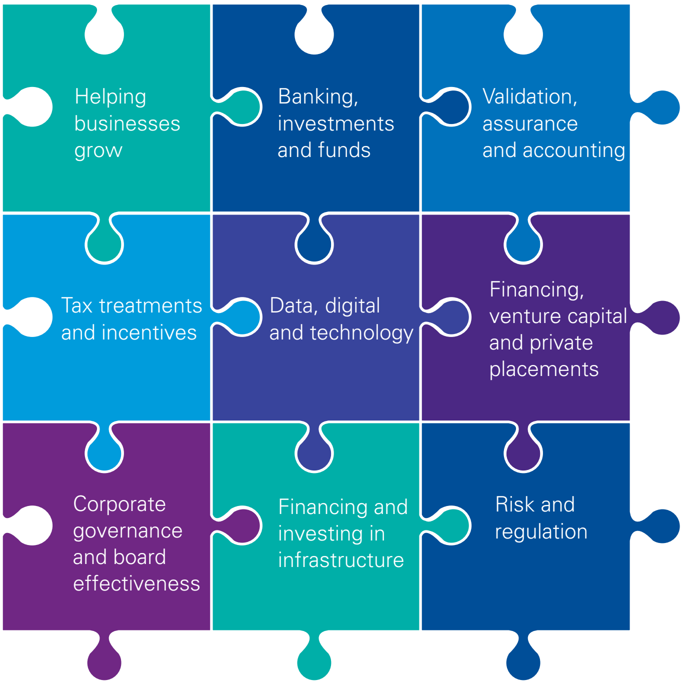
Its success has prompted similar moves elsewhere in the **UAE**, notably with the creation of the Abu Dhabi Global Market. This is also a free zone, but it is expected primarily to seek to service local wealth managers, in the same vein as Singapore.

Qatar has also got its own free zone through the setting up of the Qatar Financial Centre (QFC), an onshore center. To date, most of the QFC's members are from Dubai. Despite a major marketing initiative for the investment management and insurance sectors by the QFC over the last two to three years, the establishment of fund vehicles in Qatar has been sporadic, and the authority has signaled it will focus more on non-financial companies going forward, with leisure and tourism the priorities.

[19] Source: https://www.difc.ae/news/2015-record-breaking-year-dubai-international-financial-centre

The EU: the growth agenda assumes first place

Capital Markets Union — the new commission's approach is a break from the past 'regulate everything' approach. It encourages industry-led solutions alongside targeted legislative measures to open up Europe's capital markets and asks about the cumulative impact of post-crisis regulation.



- **Too much of EU citizens' savings in cash**
- **Review of national rules for loan-originating funds**
- **Strengthening of cross border fund passporting and competition**
- **An EU personal pension wrapper?**
- **Review of the EU retail market more generally — distribution, digitalisation, advice**

Capital Markets Union — from theory to action

While the systemic risk debate (which we turn to in Chapter 7) rumbles on, regulators are increasingly recognizing the importance of the growth agenda to balance rules that are aimed to protect against systemic risk. Heading the growth agenda in **Europe** is Capital Markets Union (CMU).

CMU is the European Commission's ambitious plan to overhaul the way Europe's capital markets work. It was inspired by the vibrancy of markets in the US and other parts of the world, which appear to have been more economically resilient to the effects of the financial crisis. The goal of CMU is to break down the barriers that are inhibiting the flow of non-bank finance into the economy, diversify the sources of funding and make markets work more efficiently. The potential size of the prize is immense if Europe can unblock cash savings and open up its markets to outside investors.

CMU represents an olive branch to the investment industry and the markets. There appears to be recognition that the "regulate everything" approach may have limited the ability of Europe's financial system to contribute to economic growth.

Some early action measures include revisions to prospectuses to help more corporates access the markets directly and also securitizations aimed at increasing lending to Small to Medium-sized Enterprises (SMEs).

More difficult issues such as insolvency and securities laws, or the way debt and equity are treated in different tax regimes, do not have quick fixes, but are flagged as areas where Europe needs to do more. In between are a range of issues where the Commission wants input from the investment industry, including increasing cross-border retail investments, consistent accounting and credit information to help SMEs access funding, and extending the covered bonds regime. The underlying theme is quality, consistency and the availability of data.

Appearing before the European Parliament in 2015 to launch the initiative, Commissioner Hill received broad support. He addressed concerns over the lack of speed of change and hinted that adjustments could be made to overly-cumbersome regulations that are still being finalized. This open-door approach to industry to talk about rules that are particularly problematic has been echoed by other Commission officials. The challenge for the industry is to provide evidence-backed arguments about rules that could impede the goals of CMU.

The European Fund and Asset Management Association (EFAMA) has indicated its firm support for CMU. Its report at its annual conference in November 2015 noted that CMU represents a big increase to the industry through initiatives to boost market-based finance, to shift household cash deposits into risk capital and to reduce the dominance of bank finance.

The Commission is concerned that retail investors are retreating from funds and recognizes that CMU can be successful only if the industry succeeds in reversing this trend. This, in turn, is likely to happen only if investors feel protected from industry malfeasance and from poor-performing products. As David Wright, then Chairman of IOSCO, said to the industry at EFAMA's annual conference: "The moment for CMU is here — seize it."

The European Commission meanwhile is looking at national regimes regarding loan-originating funds and is considering whether to issue guidelines. Martin Merlin, a Director in the Commission, told the EFAMA conference that the Commission does not intend to regulate loan-originating funds as if they were banks, acknowledging that the EU investment management sector is already well-regulated. ESMA's opinion of April 2016, however, proposes that such AIFs should be subject to authorization and additional requirements, and that they should be closed-ended. The Commission is expected to issue a consultation by Summer 2016.

The Commission is also determined to tackle barriers to the cross-border marketing of funds and to invigorate the three types of AIF subject to new product rules – ELTIFs (European Long-Term Investment Funds), EuSEFs (European Social Entrepreneurship Funds) and EuVECAs (European Venture Capital Funds).

Member States rise to the challenge

CMU vehicles are not yet widely available, but several jurisdictions are in the process of encouraging launches. The ELTIF, EuSEF and EuVECA regimes are designed by Regulation, so strictly can be established in any Member State. But some national regulators are more publicly welcoming than others.

In **Luxembourg**, the Commission de Surveillance du Secteur Financier (CSSF) has announced that an online form to launch an ELTIF and authorization to manage the ELTIF are now available on its website.

Similarly, in **France**, regulation authorizing the creation of ELTIFs was implemented in December 2015. The AMF has published a guide to help management firms navigate the new regulation and file for authorization. It is willing to answer key questions from fund managers on eligible fund types, the authorization process, management requirements and the permitted content of marketing materials.

Meanwhile, both these countries have introduced new fund vehicles for professional investors designed specifically for export, and a number of countries are facilitating the development of loan-originating funds. **Ireland** and **Germany** led the way, and **France** has now issued proposals to permit professional funds to grant loans.

In **Italy**, Mr Guiseppe Vegas, President of CONSOB, said that lending by the fund industry is no longer an option but

"The moment for CMU is here — seize it."

New fund vehicles for professional investors

Luxembourg's new Reserve Alternative Investment Fund (RAIF) structure is designed to be innovative and attract new, foreign investment. The RAIF can invest in just about any strategy and assets, and does not require approval from the CSSF. The reasoning is that it will operate under the AIMFD, so the manager will be fully authorized. In addition, it will be available only to qualified investors. The new product is being discussed in Parliament and may become available in June 2016.

A similar structure has been created in **France** through the *Société de Libre Partenariat*, or SLP. Designed to rival its Luxembourg counterpart and make French funds easier to export, the SLP is effectively a limited partnership. It is designed to attract large French and foreign investors and provide management flexibility as in limited partnerships, while giving managers and investors legal certainty. An SLP is not subject to authorization, but should be registered with the AMF within a month of establishment.

> SEBI, the Indian regulator, has allowed 'simple and performing' mutual funds to manage retirement benefit schemes that have tax benefits.

a necessity, and that the fund industry is well-placed to finance companies because banks can no longer perform this role alone.

Further stimulus to long-term savings

If CMU seeks to stimulate long-term savings in general, there are simultaneous initiatives to stimulate retirement savings in particular. The **UK's** FCA is encouraging firms to do more to support the UK's ageing population and ensure that consumers can access the financial products and services they need at every stage of their life. It is seeking comment on the issues raised and on the scope of the project by 15 April 2016. The strategy will be launched in 2017.

The FCA says the industry "must take the lead", while it has a key part to play in encouraging innovation that also provides proper levels of protection for consumers. It is keen to show that products and services cannot be designed for a "typical" consumer and must be flexible enough to capture individual situations. Consumer organizations have commented that financial products and services must be able to adapt to meet the diversity of needs that are relevant for older consumers.

Similarly, in **France**, there has been a push to stimulate retirement provision, through the existing "PERCO" regime. The PERCO, a collective retirement plan, allows employees to use employment savings as a complement to retirement savings and take one of two possible forms of withdrawal at retirement: an annuity or a cash payment.

The law for growth, activity and equal economic opportunities of July 2015, also known as the Macron Law, has reinforced the role of employee savings in the long term financing of the economy. From January 2016, unless specified by an employer, funds invested in a PERCO are managed on the pre-defined basis. This is similar to "target-date plans" that are popular in the US and ensures that the financial risk is reduced as the date of retirement approaches, while still allowing some exposure to equity markets.

At the same time, though, fiscal incentives are being reduced in some countries, especially for higher earners. In the **Netherlands**, the accrual rate for pensions is being lowered from 2.15 to 1.875 percent and for those with annual income above EUR 100,000 the normal pension framework is no longer available. The **UK**, too, is reducing fiscal incentives for higher earners.

India is currently particularly active in trying to stimulate the domestic investment environment and reforming regulation seen as hindering investment, especially from foreign investors. The Securities and Exchange Board of India (SEBI), the Indian regulator, has allowed "simple and performing" mutual funds to manage retirement benefit schemes that have tax benefits. SEBI is also encouraging investment in other areas through The Indian Finance Act 2015. The Act is particularly pertinent to general and limited partners in Indian private equity funds. It provides a special tax regime and allows foreign investment in alternative investment funds. The special tax regime gives a tax pass in respect of all income other than business income, which also applies to funds invested in start-up or early stage ventures, social ventures, small and medium enterprises, infrastructure or other areas that the government considers as socially or economically desirable.

However, all non-business income payable to investors will be subject to withholding tax at the rate of 10 percent, which may deter foreign investors from investing into these funds. In the absence of precise criteria to distinguish business income from capital gains, there is a risk that the withholding tax will also be imposed on other exempt income such as dividends and long-term listed gains.

In addition, India has now created concessions for Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs). The Act introduces changes to the taxation regime for REITs and InvITs, with the pass through status currently given to investors for interest income earned by REITs from SPVs extended to rental income earned from property held by the REIT. An attractive capital gains tax regime will be available to sponsors of REITs who acquire units through a swap of SPV shares.

In **Thailand**, the regulator in January 2016 revised several regulations to enhance the flexibility of the investment policies of mutual funds and provident funds (PVD). The amendments, approved by the Capital Market Supervisory Board, aim to increase the competitiveness of Thai-based investment management business.

Revisions to regulations include:

- The determination of types and characteristics of investible assets to be based on principles instead of specific details.
- Permission for mutual funds to invest in more types of assets, depending on suitable risk profile. For example, funds offered to retail investors are now allowed to invest in non-listed infrastructure funds on the condition that pre-specified ratios apply.

— Relaxation of PVD rules by increasing the permitted investment proportion of PVDs in property funds and infrastructure funds from 15 percent to 30 percent of the net asset value (NAV). In addition, to offer more choice to PVD members, it allows the establishment of PVDs as sector-focused funds.

— Promotion of investment diversification, in line with international standards and market development.

— Derivative investments are allowed in accordance with international standards.

The regulator in **Japan** is aiming to encourage asset formation and supply of growth capital through operational improvements, as well as ensure ongoing market development. The two main priority measures set out by the regulator are, first, the further popularization and development of the Nippon Individual Savings Account (NISA), including encouraging further uptake among eligible individuals and promotion of the Junior NISA scheme. Second, there are plans to create specially designed locations, complete with appropriate infrastructure, for hedge funds and small and medium-sized investment managers, as part of a Tokyo Metropolitan Government-led strategic initiative.

As part of the project, attracting overseas platform providers, which could take on the middle and back office operations (and contribute to cost efficiency) of the smaller investment managers, is being considered. The initiative is looking at the examples of US and Singapore where such platforms successfully function as a business and have attracted the custom of hedge funds.

In terms of pension provision, in September 2015, the Defined Contribution (DC) Pension Plan Law Reform Bill was passed by the Lower House in Japan. It includes significant expansion of the subscriber base to individual DC plans and operational improvements.

Currently, subscriptions to individual DC plans are limited to the self-employed and those working at private sector companies without a corporate pension scheme. The reform will expand this subscriber base by abolishing most restrictions, and will allow civil servants, subscribers to corporate pensions and homemakers to join the individual DC scheme.

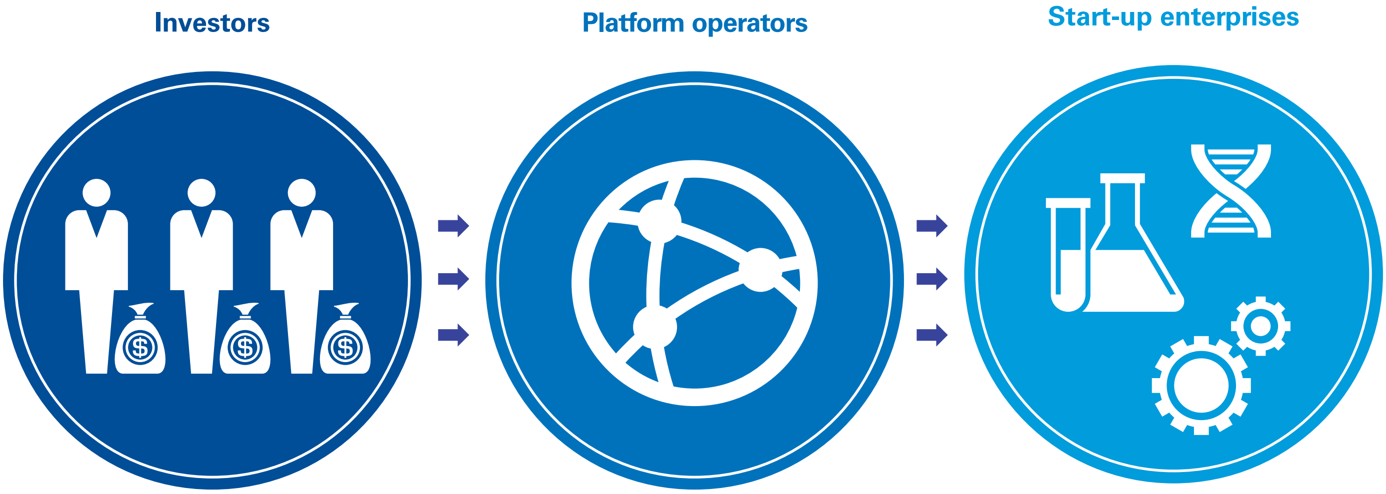
The reform also introduces the "specified operating method" to support long-term diversified investment, either for individuals who have not specified the investment of their subscriptions or to those unable to execute diversification while understanding the need for it in their portfolios.

In **Canada**, there has been much debate about pension reform at the provincial and federal government levels, driven largely by the impact of people living longer in retirement and the continued trend of declining savings rates by individuals. Some provincial governments have proposed or are implementing government-run provincial pension plans, similar to the existing federally-run Canada Pension Plan, for which many are calling for increased employee and employer contributions. The federal government is establishing the concept of Pooled Retirement Savings Plans for employees of companies that do not offer company pension plans.

Crowdfunding goes mainstream, regulators follow

Crowdfunding continues to concern, and sometimes perplex, regulators. Its rapid expansion in a short period of time has forced regulators to carry out analyses and to try to formulate an appropriate response. While the emergence of crowdfunding has

Regulators facilitate crowdfunding



been welcomed in many countries, regulators are trying to strike a balance between investor protection and stimulating economic growth via funding for small companies.

In the **US** — by far the largest crowdfunding market — the SEC in November 2015 adopted final rules to permit companies to offer and sell securities through crowdfunding. The new rules and proposed amendments are designed to assist smaller companies with capital formation and provide investors with additional protections. The final rules (effective 180 days from publication in the Federal Register on 29 January 2016) permit individuals to invest in securities-based crowdfunding transactions up to certain investment limits. The rules also limit the amount of money an issuer can raise using the crowdfunding exemption, impose disclosure requirements on issuers for certain information about their business and securities offering, and create a regulatory framework for the broker-dealers and funding portals that facilitate the crowdfunding transactions.

A number of **European** countries are putting in place national regimes to facilitate the growth of crowdfunding while recognising the characteristics and needs of their local markets. On 3 May 2016, the European Commission issued a working document, whose conclusion was that an EU framework was not necessary at this stage, but that it would continue to monitor market developments and encourage alignment of national approaches.

In the **UK** — the largest European crowdfunding market — especially for loans, a new Innovative Finance ISA (Individual Savings Account) allows investors to access peer-to-peer loans from April 2016 and the list of qualifying investments for the new ISA will be extended in autumn 2016 to include debt securities offered via crowdfunding platforms.

In **Jersey**, there is currently a debate about whether and how crowdfunding fits into the regulatory regime. The industry is debating whether crowdfunding can be considered a fund activity, and it is looking at how they are marketed and under what codes of practice.

Meanwhile, the crowdfunding market in **Asia** has grown rapidly and is now slightly larger than the European market. In **Japan**, crowdfunding is seen as a way to help revitalize the long-stagnant economy. The regulator now allows businesses to procure small amounts of funding from the general public by issuing shares online. Companies planning to issue shares in this way will operate under substantially simpler rules on information disclosure than companies listing shares on stock exchanges. However, they will be able to receive investments of up to only JPY 500,000 per investor and to raise no more than JPY 100 million in total.

In **Singapore**, in order to facilitate access by start-ups and SMEs to more sources of funding, the MAS is proposing measures to facilitate crowdfunding that involves the offer of securities to accredited and institutional investors. In particular, MAS proposes to relax certain financial requirements for capital markets intermediaries that deal in securities, which will benefit certain intermediaries that operate crowdfunding platforms.

Canadian regulators have recently created a registration framework applicable to online crowdfunding portals. However, investment funds are not able to use crowdfunding in Canada.

> “The crowdfunding market in Asia has grown rapidly and is now slightly larger than the European market.”

Chapter 5

Technology – will regulators become robocops?

Although the investment management industry has been relatively slow to adopt new technology, it is catching up fast. While this is positive for many firms, it also brings challenges. Introducing new processes and distribution channels always takes time to bed down and much of the technology is at an experimental stage. This has not gone unnoticed by regulators, which are looking at developments and starting to conduct research, reviews and consultations.

In particular, they are questioning whether they need to extend the regulatory perimeter to cover new digital distribution channels and, if so, how.

Automation in financial advice

Robo-advice (an automated distribution channel) is entering the mainstream within the retail and wealth segments in developed markets. On many robo-advice platforms, customers can simply visit a website, answer questions about their personal and financial circumstances, and computer programs will then suggest an investment strategy.

Fees are considerably lower than those of traditional financial advisors and robo-advice is seen by advocates as a middle way between personal investment research and face-to-face advice. However, there is concern that this could lead to small investors being offered less effective advice than wealthier investors, which could put their savings at risk. As a result, regulators worldwide are starting to review robo-advisory offerings.

In **Europe**, the ESAs requested responses by March 2016 to a discussion paper on automation, which notes: "Consumer awareness of automated financial advice tools seems to be low and financial literacy of consumers has been shown to be limited."

The ESAs cite an estimated 19 percent growth rate in digital banking, recent growth in the US market in the use of automated tools and a general increase in the level of digitalization in financial services as evidence that automated tools are gaining importance, with the securities sector leading the banking and insurance sectors.

The paper considers the potential benefits and potential risks, to both consumers and firms, of this increasing phenomenon. For example, it identifies benefits to consumers as costs, ease of access, consistency, service quality and an identifiable audit trail. Risks include limited ability to process the output, potentially unsuitable advice due to the quality of information input or bias in the tool, flaws in the tools and an incorrect perception that the output is "financial advice". The range of issues discussed appears sensible, but the current approach seems to assume that the traditional face-to-face advice world is without flaws.

At this stage, the ESAs are simply opening a debate under their obligation to monitor new and existing financial activities. There is not yet any indication that they will recommend the introduction of new rules. However, when coupled with the Commission's work under CMU to increase choice, competition and efficiency in retail financial markets, there appears to be increasing recognition among regulators that the regulatory boundaries between "advice" and "information" need to be re-assessed.

US regulators, on the other hand, have been relatively relaxed over robo-advice to date. Rather than seeking to restrict or regulate it, the SEC and the Financial Industry Regulatory Authority (FINRA) have employed *caveat emptor*.

However, they are starting to warm to the theme: in May 2015, they warned investors against systems that promised good performance. They also said that robo-advice may make wrong assumptions: "If the automated tool assumes that interest rates will remain low but, instead, interest rates rise, the tool's output will be flawed," the SEC warned. It highlighted that robo-advice might offer products only from the provider offering it and advised investors to protect their identities.

SEC Commissioner Kara Stein said in 2015 that the organization would assess the situation. She said: "Do we need certain tweaks and revisions? Do investors appreciate that... robo-advisers will not be on the phone providing counsel if there is a market crash?"

In September 2015, in response to some **Canadian** registered portfolio managers and restricted portfolio managers starting to operate as "online advisers", the Canadian regulator clarified that there is no "online advice" exemption from the normal conditions of registration for an investment firm. Registration and conduct requirements are "technology neutral" and the rules are the same if a manager operates under the traditional model of interacting with clients face-to-face or uses an online platform.

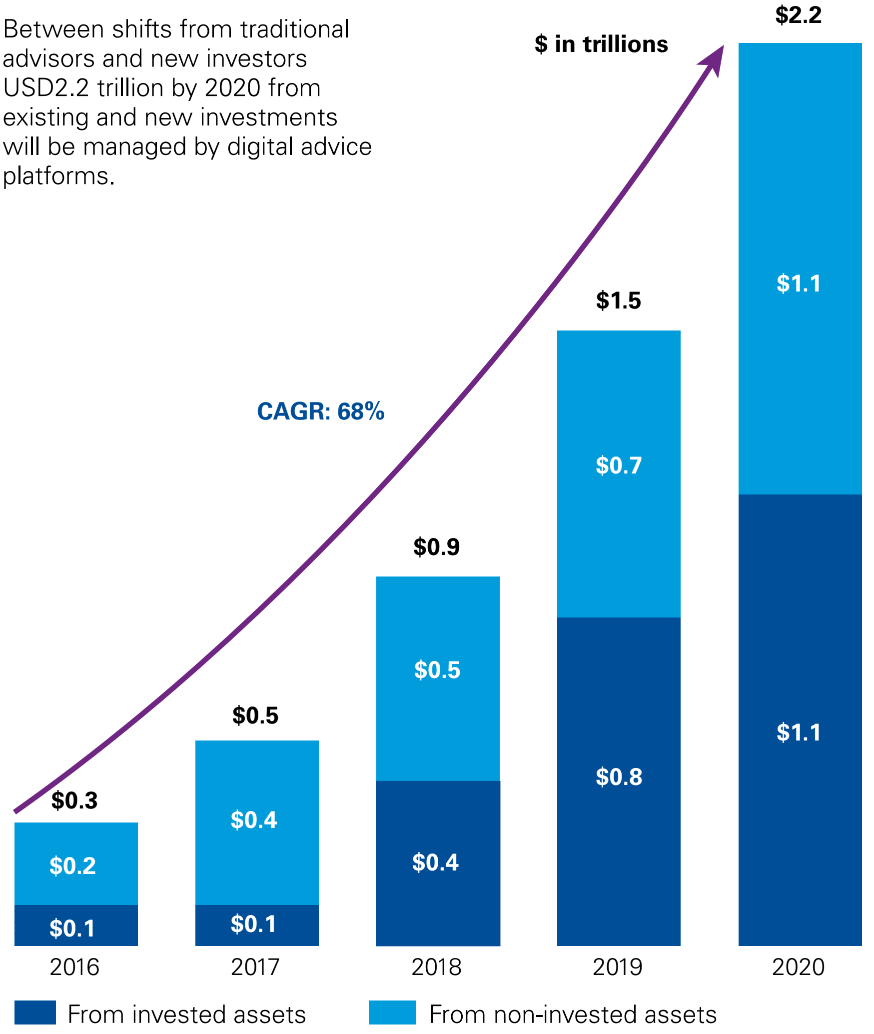
This clarification makes Canada arguably one of the most regulated jurisdictions for robo advice. Prior to launching an online advice platform, a manager must file substantial documentation, including their proposed KYC questionnaire and information about the processes relating to its use. The online adviser's KYC process must amount to a meaningful discussion with the client or prospective client, even if that discussion is not in the form of a face-to-face conversation. Clients should have the opportunity to initiate live interaction with an adviser by telephone, video link, email or internet chat.

To date, the CSA have approved only online advisers with relatively simple product offerings. They say portfolios with uncomplicated asset allocation models, made up of relatively basic ETFs or mutual funds, are readily understood by most investors and determining whether they are suitable for a given investor is a comparatively straightforward exercise. If a manager wants to use more complex investment products on an online platform, the CSA will assess whether it can meet its regulatory obligations.

In **South Africa**, the current legal regulation of internet-based financial services is not as stringent as traditional financial regulation. The regulator says that apart from gaps in legislation, difficulties arise from customer verification, which may be compromised if the financial service provider and customer never meet and it is difficult to apply traditional customer verification procedures. It is also concerned about providers in foreign countries that have different regulatory provisions for online transfers.

Projected US robo-advisors assets under management

Between shifts from traditional advisors and new investors USD2.2 trillion by 2020 from existing and new investments will be managed by digital advice platforms.



Source: *Robo Advising: Catching up and getting ahead,* KPMG International 2016

Robo-advice has become a major issue in **Australia** under the FoFA review. As in Canada, FoFA is agnostic whether advice is given by computer or a person, and regulatory duties must be met. ASIC has issued a draft Regulatory Guide and consultation paper seeking submissions on supervisory matters, largely around competency of the license holder providing the robo-advice and the ongoing monitoring of the algorithms. Currently, there are few automated platforms in the country but, if they proliferate, the regulator is likely to raise its supervisory activity.

In the **UK**, the FCA is discussing, in conjunction with HM Treasury, ways of improving client access to financial services, which includes looking at robo-advisory services. The consultation results were released in mid-March 2016. The seven-month study, known as the Financial Advice Market Review, concluded that automated advice could "play a major role in driving down costs". The FCA has a new advice unit to help investment firms set up automated platforms.

The review was looking to fix a problem created by the RDR, whereby advisers no longer receive commissions for placing funds with managers. The result is that many banks have withdrawn from the advisory business and robo-advice is gaining prominence. Robo-advice could also be attractive to people who have taken control of their own pension pot after long-standing rules compelling retirees to buy annuities were jettisoned.

Regulators as drivers of FinTech

FinTech is becoming a major driver for innovation in the investment industry worldwide. Some regulators have seen this as an opportunity for businesses in their jurisdictions and have taken steps to promote the industry locally.

In the **UK**, for instance, the FCA has helped FinTech companies to navigate regulatory complexity through programs such as Project Innovate, which includes a "Regulatory Sandbox" that will enable businesses to test out new products and services in an environment exempt from standard regulations. The strength of the UK policy environment is seen as due to the supportiveness and accessibility of the FCA, effective tax incentives and numerous government programs designed to promote competition and innovation, which indirectly support FinTechs.

Regulators in **Singapore** and Australia have also taken an active interest in the FinTech sector. In Singapore, the regulator has established a FinTech steering group and replicated the UK model of an Innovation Hub. Singapore's MAS has made a commitment of around SGD225 million over the next five years to fund innovation labs, institutional-level projects and industry-wide initiatives.

In **Australia**, APRA and ASIC, in the wake of the Australian Financial System Inquiry, are establishing a permanent public-private collaborative committee to facilitate financial system innovation. It is proposed to be set up by mid-2016. The Innovation Hub has been developed to help new FinTechs navigate ASIC's regulatory system. This includes making senior staff available at open events to respond to questions.

In the **US**, the Department of Business Oversight in California and the Department of Financial Services in New York have introduced regulatory initiatives specifically aimed at engagement with, and support of, FinTechs. **Germany** has made similar moves, through BaFin.

Development of blockchain in the investment industry

Advocates of blockchain say the technology could speed up inefficient back offices and save billions in the amount of collateral that is required by the global financial system.

Blockchain allows a digital asset to be moved between counterparties without using a central ledger to record the deal. The technology aims to prevent fraud by using a public digital database that is continuously maintained and verified by the other computers in a chain of transactions.

Use of the technology took a step forward in February 2016 when the **Australian** Stock Exchange said it would become the world's first market to settle equities trades using blockchain.

And ASIC, the Australian regulator, is talking to a number of finance services organizations about the use of blockchain and the implications for markets. A consortium of banks is in discussions about building new payment platforms that in the investment management industry could lead to real-time transactions and settlements. Clearly, this would have a substantial impact on custodians and back office functions.

Regulators are watching developments such as these with a measure of concern. Greg Medcraft, chairman of IOSCO, said the technology was potentially "good for investors and issuers"[20] but it still needed to reassure investors that their transactions were safe. "At least at the start, exchanges will have to guarantee the customer behind [the trade]," Mr Medcraft said.

[20] Source Financial Times, February 2016

Chapter 6

Rising cyber security threat prompts regulatory reaction

The increasing use of technology and proliferation of data has provided the market with new products, services and channels for clients. Unfortunately, it has also increased the likelihood of their data, or even their assets, being stolen. As a result, cyber security is now a global agenda item for regulators, and IOSCO views it as a key systemic threat. However, few common approaches have emerged to date.

The recognized global standard is the US National Institute of Standards (NIST) cyber security framework, which sets out standards for cyber security controls. This framework is increasingly being referenced by regulators and financial institutions worldwide as a way of structuring and reporting control effectiveness, but there is not yet consistency in the adoption and practical application of the standards within the sector.

Growing size and sophistication of cyber risk

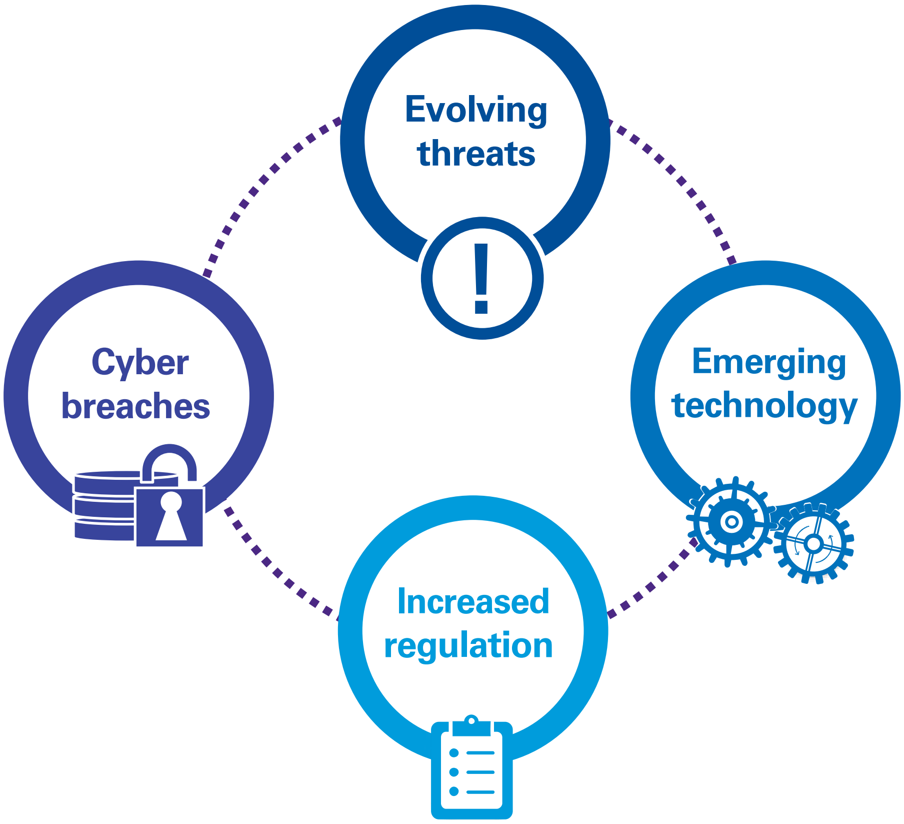
On 6 April 2016, IOSCO issued a study of regulatory approaches and tools to deal with cyber risk. The report notes that cyber risk constitutes a growing and significant risk to the integrity, efficiency and soundness of financial markets worldwide. It also underlines that the human element of cyber risk, combined with rapidly evolving technologies in securities markets, suggests that this topic requires swift and sustained attention by regulators and market participants

In its Risk Outlook for 2016, IOSCO says that the "cyber threat environment" is typically assessed by the investment industry as an IT-related risk. However, cyber threats should be thought of in a much broader context than just IT. Some characteristics that define the scope of cyber threats and distinguish them from IT-related risks include the fact that cyber threats are not accidental or incidental; are not caused by non-malicious errors or omissions; are not due to natural or man-made disasters; and are not instances of technological "glitches" or software errors. Cyber threats are malicious and planned intrusions that people orchestrate.

The highest profile attacks have been on banks, where individuals' and companies' accounts have been hacked and data or funds stolen. But the investment management sector is increasingly a target too. There have been reports of spear fishing attacks, the stealing of trading information or algorithm codes, and cases of hedge funds being locked out of their computer files by hackers. Fund administrators have more recently been targeted.

The increasing frequency and size of attacks is feeding a growing body of cyber security regulation. But there is little international consistency in rule-making.

Cyber security landscape



The US has led the way on regulatory intervention…

The **US** is possibly the most active on cyber security, and the SEC is substantially toughening its approach to the issue. Until now, the SEC had taken a strong public stance but had not directly acted. Towards the end of 2015, however, it censured an investment company after a cyber-attack exposed information on 100,000 of its clients. This enforcement action sent a clear message about the SEC's future expectations: investment firms must get their cyber defenses in order.

Prevention has become the watchword of the cyber security enforcement agenda. A series of public statements by the SEC promised to hold investment companies and their leaders accountable if data security standards are below standard. In October 2015, Mary Jo White, Chair of the SEC, said it was incumbent on financial companies to develop robust, state-of-the-art plans against cyber-attacks.

The SEC announced a new cyber security examination initiative for US-registered investment advisers. The initiative includes significant and detailed steps towards creating a broad platform of cyber security safeguards that touch on critical areas of an investment firm's operations. The move followed the SEC's cyber security analysis conducted in 2013-14, which revealed that 74 percent of investment advisers had experienced a cyber-attack.

Despite a package of legislative reforms proposed as long ago as May 2011, cyber security may have languished as a low priority item for longer had President Obama not issued an Executive Order back in February 2013 on "Improving Critical Infrastructure Cyber security" to address the information security of critical national infrastructure. Congress finally agreed the Cyber Security Information Sharing Act in December 2015 and in February 2016, President Obama went a step further, creating by Executive Order two new entities.

The first, the Commission on Enhancing National Cyber security, is comprised of business, technology, national security and law enforcement leaders who will make recommendations to strengthen online security in the public and private sectors. It has been tasked with delivering a report to the President by December 2016.

The second, the Federal Privacy Council, will bring together 25 federal agencies in order to co-ordinate efforts to protect the data the federal government collects and maintains about its taxpayers and citizens.

FINRA has also stated that information security remains a priority, with concerns over the integrity of firms' infrastructure, and the safety and security of sensitive customer data. Its focus remains on the integrity of firms' policies, procedures and controls to protect sensitive customer data. A targeted assessment of information security is underway. Its examination priorities for 2016 include a review of governance, risk assessment, technical controls, incident response, vendor management, data loss prevention and staff training. FINRA will also be assessing the vulnerability of high frequency and proprietary trading systems. While its work is focused

What are we trying to prevent?

The threats can be extortion, ransomware, vandalism, theft of personally identifiable information and/or actionable intelligence (phishing).

Theft of client information

— names and contact information

— investment details

Denial of service

— access to pension funds through communication channels

Supplier compromise

— fund administration

— IT supplier

Theft of intellectual property

— investment strategy

— allocations

Theft of corporate data

— employee data

— payroll data

Front running trades and data manipulation

on banks and brokers, there will be a tangible impact on investment managers, particularly those owned by banks.

The SEC issued guidance on disclosure of information security risks and incidents that have a material impact on a firm's performance, and also issued specific guidance for the investment management sector in April 2015 requiring periodic assessment of security controls and a strategy for preventing, detecting and responding to attacks.

…and regulators around the globe are now taking action

The Investment Industry Regulatory Organization of **Canada** included cyber security as a 2015 priority area for Dealer Members. And the IFIC[21] and AIMA[22] (Canada Chapter) have working groups and seminars on cyber security. In addition, the CSA has issued staff notices reminding registrants and reporting issuers, including investment managers and certain funds, of their requirements relative to cyber security.

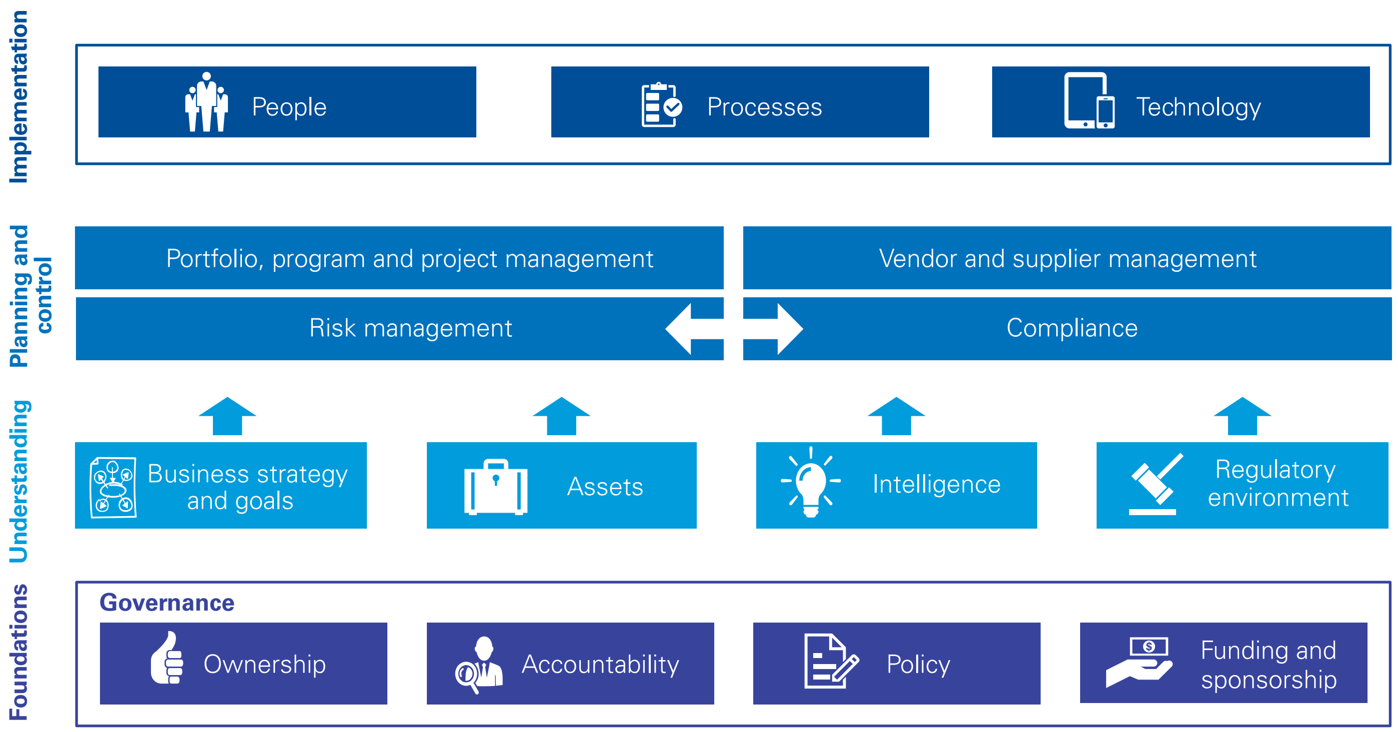
The emphasis of the **Australian** regulator is currently on monitoring of cyber security issues. ASIC said in November 2015 that cyber security is one of its five key challenges for 2016, but it does not envisage taking enforcement action at this stage. On 21 March, the Securities Commission of **Malaysia** invited suggestions and feedback on the combatting of cybercrime.

In November 2015, in view of the fast evolving nature of cyber risk and after issuing guidance on the training of boards, **Singapore's** MAS demanded that the board of an investment manager be regularly apprised on salient technology and cyber-risk developments. Firms should have in place a comprehensive technology risk and cyber security training program for the board. The program may comprise periodic briefings conducted by in-house cyber security professionals or external specialists.

In **Japan**, the regulator published the Policy Approaches to Strengthen Cyber Security in the Financial Sector in July 2015. The paper outlines five policies:

1. Constructive dialogue with financial institutions and grasp of their current condition regarding cyber security
2. Improvement of the information sharing framework among financial institutions
3. Continuous implementation of industry-wide cyber security exercises
4. Cyber security human resource development in the financial sector
5. Arrangement of cyber security initiatives in the regulator

Cyber security capability model



Source: Evolving Investment Management Regulation, June 2016, KPMG International

[21] Investment Funds Institute of Canada
[22] Alternative Investment Management Association

In the **UK**, regulatory requirements say that firms must establish, implement and maintain adequate policies and procedures sufficient to ensure compliance with their objectives under the regulatory system and for countering the risk that the firm might be used to further financial crime. The "Financial Crime: a guide for firms" was published in April 2015. This guide also covers related anti-money laundering requirements.

Notably, Andrew Gracie, an Executive Director of the Bank of England (BoE), made a major speech in July 2015[23] signaling the BoE's intentions for information security. He emphasized a holistic (people, process, technology) approach to protection, the need for investment, regular vulnerability testing, an emphasis on recovery and resilience and appropriate governance. He also announced a joint work program between the BoE, the FCA and HM Treasury to consider whether further regulatory action is required.

In **Guernsey**, the Financial Services Commission in March 2016 issued regulatory guidance on cyber security. Any serious or significant incident involving data loss, financial loss or denial of service type attacks, whether actual or prevented, must be reported to the Commission in a timely manner. The ability for firms to provide a secure and uninterrupted service should form an important part of their operational risk considerations. Firms need not only to build defensive resilience to such attacks but also to have the capability to recover quickly from the impact of a successful breach.

In **China**, the government issued two circulars in 2014 requiring that banks strengthen their information security and move towards a position where they use IT that is "secure and controllable". The aim is for 75 percent adoption by 2019. In practice, this includes a move away from closed source systems — which are not easily open to inspection — to open source environments. There is an increased emphasis on supply chain security issues.

The **Hong Kong** Monetary Authority issued a circular on cyber security risk management in September 2015, with a KPMG summary of the implications published in the same month. The risk management regime includes: clear ownership of cyber security risk; periodic control benchmarking and reporting; incident reporting; proactive contingency planning; and regular independent assessments.

In **Ireland**, the CBI is carrying out a review to see if firms have thought seriously about IT risk and how they can manage it. Cyber security continues to be a major area of focus for investment management supervisors. In 2015, they reviewed cyber security and operational risk in investment firms, fund service providers and stock brokers, and are extending this review in 2016 to look at the resilience of IT systems within regulated entities, with a view to determining the scale of the investment required to counter cyber risk.

The main conclusion of last year's review was that firms need to embed a broader awareness of cyber risk among their staff and that a culture of risk awareness needs to be driven from the board. The CBI highlighted poor management of cyber security as a significant threat to investor protection, market integrity and financial stability and that firms need to put effective systems and procedures in place to protect against cyber risk and related operational risks. For example, firms should have appropriate processes in place to verify the legitimacy of all requests received via all methods of communication (including telephone and email). In order to unearth vulnerabilities, firms should consider engaging the services of an external specialist to carry out a penetration test of their systems on a regular basis and that such tests should take place at least annually.

In **Qatar**, the central bank is reviewing cyber security across the banking and investment sector. The Qatar government has set up a legal entity to look at cyber security. Q-CERT was due to carry out its third National Cyber Security Drill in 2016 designed to train and assess organizations' capabilities in responding to incidents and managing crises.

Key questions for firms

- **Do you have the right level of protection for your most valuable information?**
- **What would the impact be on your business if you suffered a cyber security breach?**
- **How do you know you haven't already suffered one?**
- **How are you managing your suppliers to ensure they are not a weak point in your security?**
- **How do your cyber security capabilities compare to your peers?**

[23] http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech835.pdf

Protecting client data is an imperative

In **Switzerland**, the Swiss financial market supervisory authority amended circular 08/21 in March 2015 to include a new appendix on the handling of client data. The amendment sets out governance, access controls, security standards, selection and training of employees, risk management, incident handling and outsourcing controls. This builds on 2013 guidelines by the Swiss Banking Association on Data Loss Prevention.

There is wide political will in **Europe** to strengthen data protection legislation. In addition to the Network and Information Security Directive, which is set to come into force August 2016 and must be implemented by May 2017, the new General Data Protection Regulation (GDPR) comes into force in the spring of 2018 and aims to bring Europe into the digital age. It contains a number of new protections for EU data subjects' personal and sensitive information, and will impose significant fines and penalties on non-compliant organizations. Although the focus of the GDPR is on the protection of personal data through restrictions around data collection, sharing and cross border transfers, data security plays a prominent role in the new law.

The GDPR imposes broader extra-territorial controls on the processing of personal data by non-EU controllers who collect personal data through the provision of services to EU citizens, fines of 2–4 percent of annual turnover, and stricter obligations on data processors and controllers, while simultaneously offering more guidance on appropriate security standards. The GDPR also adopts specific breach notification guidelines, with certain breaches having to be notified to the local regulator within 72 hours.

In the **Netherlands**, the Breach Notification Law came into force in January 2016. The law, which is GDPR in style, introduces a general obligation on data controllers to notify the Dutch Data Protection Authority of data security breaches and provides increased sanctions for violations of the Dutch Data Protection Act. Failure to comply can lead to administrative fines of up to EUR 810,000 or 10 percent of the net turnover of the company.

Chapter 7

Systemic risk debate deepens

With stable economic growth still a scarce commodity, regulators find themselves walking a tightrope to protect the financial system while allowing breathing space for economic recovery. National and regional governments are encouraging regulators to balance investor protection initiatives with an economic growth agenda. At the same time, however, the debate on whether investment managers and investment funds are systemically risky rumbles on.

Over the last year, regulators have pulled back from the idea of designating certain investment firms and funds as "systemically important". Instead, they are now focusing on investment management activities and the way that open-ended investment funds, in particular, are managed.

Various international bodies and agencies are contributing to the ongoing policy debate, which seems to remain polarized. While discussions between policy and rule makers continue, however, the industry is seeing an increased number of *ad hoc* data and information requests, especially in relation to investment funds. Also, there are demands for greater stress testing of funds.

Shifting sands

In the 2015 EIMR report, we noted that the International Monetary Fund (IMF), the Bank for International Settlements (BIS), the FSB, IOSCO and the US Financial Stability Oversight Council were all considering designating some of the largest investment firms and funds as "systemically important". Similar labels assigned to lenders and insurers have resulted in more rigorous scrutiny, higher capital and liquidity requirements and stress tests.

But this global effort to label the biggest investment managers as systemically important and subject them to greater scrutiny, appears to have weakened. At its June 2015 meeting in London, IOSCO opined that it was more important to focus on the risks posed by the sector as a whole than to focus on supervising a small number of (albeit) very large firms. The comments by IOSCO executives ran counter to the aims of the FSB, the Basel-based umbrella group of central bankers and policy makers, which was in favor of a systemically important label.

IOSCO's position thus moves into line with the **UK's** FCA, whose then Chief Executive, Martin Wheatley, questioned the value of designating firms as systemically important.[24] The shift also suggests that securities regulators are ceasing to copy wholesale reforms made in the banking sector, and are instead looking at investment management as a discrete industry.

The subsequent meeting of the FSB in September 2015 seemed to confirm that it had moved towards IOSCO's position, with no further mention of focusing on specific investment firms. And in February 2016, Mark Carney, FSB Chairman, wrote to the G20 and central bank governors, setting out its current focus for the investment management sector. The focus is on aggregate risk rather than firm-specific risk:

1. Liquidity mismatch in funds
2. Leverage within funds
3. Operational risks in transferring investment mandates
4. Securities lending activities of investment managers and funds.

Mr. Carney said the FSB would be analyzing vulnerabilities associated with these investment management activities and would issue policy recommendations for consultation before the G20 Hangzhou Summit in September 2016. The FSB and IOSCO will then conduct further analysis and finalize the assessment methodology for investment management under the global systemically important financial institutions (G-SIFI) framework. This analysis will focus on any residual risks once measures to address these activities are taken into account.

Under the G20 shadow banking roadmap, the FSB will also evaluate in 2016 the case for further recommendations to mitigate financial stability risks from shadow banking entities, By July 2016, the FSB is due to publish its peer review on the implementation of the Framework for Oversight and Regulation of Shadow Banking.

In March 2016, IOSCO again underlined its stance, saying there is no evidence that large investment managers or individual funds pose systemic risks. In its Securities Markets Risk Outlook 2016, IOSCO says there is no evidence of "contagion or systemic events following fund liquidity stress events outside the money market fund space". It says mutual funds in general post greater net inflows than outflows and enjoy a stable investor base. It emphasized that even if large funds face significant redemption requests, this does not automatically trigger a systemic event. In particular, it does not appear to be overly worried by

[24] Source: Financial Times, June 2015

National regulators to gather more data and information on how risks in and to investment funds are being managed.

risk in bond markets: it found that liquidity in secondary market corporate bond markets, as measured by bid-ask spreads and price impact from November 2008 to November 2015, has not fallen.

Despite the lack of evidence that investment managers or funds pose a threat to financial stability, IOSCO said there is still need for further work to fully understand risks in investment management. It is therefore encouraging national regulators to gather more data and information on how risks in and to investment funds are being managed.

The policy debate is far from over, however. In February 2016, the New York Federal Reserve published a blog arguing that investment managers are vulnerable to "fire sales". The blog argues that bond funds are more at risk of fire sales than their equity counterparts. Macro-prudential stress tests show that mutual funds can be subject to a "run" because they are open-ended, despite the fact that they have no significant leverage. In addition, the stress test shows that such a run can produce significant negative spillovers in asset markets through forced liquidations, the blog concluded. It is of note, though, that US mutual funds are not yet subject to specific rules on liquidity management.

Disclosure and calculation of leverage in focus

Given the turbulence in financial markets and the sheer issuance of bonds in the period since the Financial Crisis, it is perhaps unsurprising that policymakers are paying particularly close attention to leverage and liquidity.

In February 2016, the IMF called for fund managers to be more transparent about the levels of leverage they use in bond mutual funds, amid concerns that excessive leverage could trigger a market crash. According to IMF research, bond funds have increased their use of derivatives substantially since the global financial crisis.

"The less transparent things are, the greater the risk of negative surprises," said Fabio Cortes, an economist in the IMF's monetary and capital markets department. Mr Cortes published a blog post calling on regulators to demand better disclosure of funds' deployment of derivatives.[25]

An important reason why the IMF seeks greater transparency is that it is currently difficult to ascertain whether high leverage levels are adding systemic risk to bond markets. It believes that reporting standards should include enough leverage information (level of cash, assets and derivatives) to show mutual funds' sensitivity to large market moves and to facilitate meaningful analysis of risks across the financial sector.

In March 2016, Vitor Constancio, vice-president of the European Central Bank (ECB), said in a speech that the EU has to "develop a framework to better control the leverage of alternative investment funds" across the bloc. Mr Constancio said that the EU needs to increase its supervision of hedge funds and private equity as these vehicles could potentially destabilize Europe's markets. He told investment funds to keep leverage at acceptable levels or it could "create and amplify systemic risk".

Information on leverage levels in **European** funds is already available because it is a requirement under UCITS and AIF legislation. But, under current

[25] Source: Financial Times, February 2015

UCITS rules, it is not obvious whether derivatives actually increase leverage. Leverage must be calculated on a gross exposure basis, which means the values of all derivative positions are added together, even though they hedge different exposures. This simple addition can overstate the amount of leverage.

Also, in **Ireland**, the CBI warned in February 2016 that the way AIFs measure leverage needs to be addressed. The Irish regulator said the concept of leverage under the AIFMD is currently too broad. It cited AIFMD leverage metrics — the "commitment" and "gross" methods — that embrace a broader set of risks than those associated with other external credit finance, such as margin financing or borrowing. It argued for the setting of appropriate leverage limits during a future review of AIFMD, which the European Commission is due to complete by July 2017.

In the **US**, there is no requirement to make disclosures, although the SEC said in December 2015 it was considering imposing such a rule. The proposed SEC regulation would limit funds' deployment of derivatives and require risk management measures aimed at improving investor protection. The SEC wants funds to manage the associated risk by segregating enough collateral to cover all obligations, even "under stressed conditions".

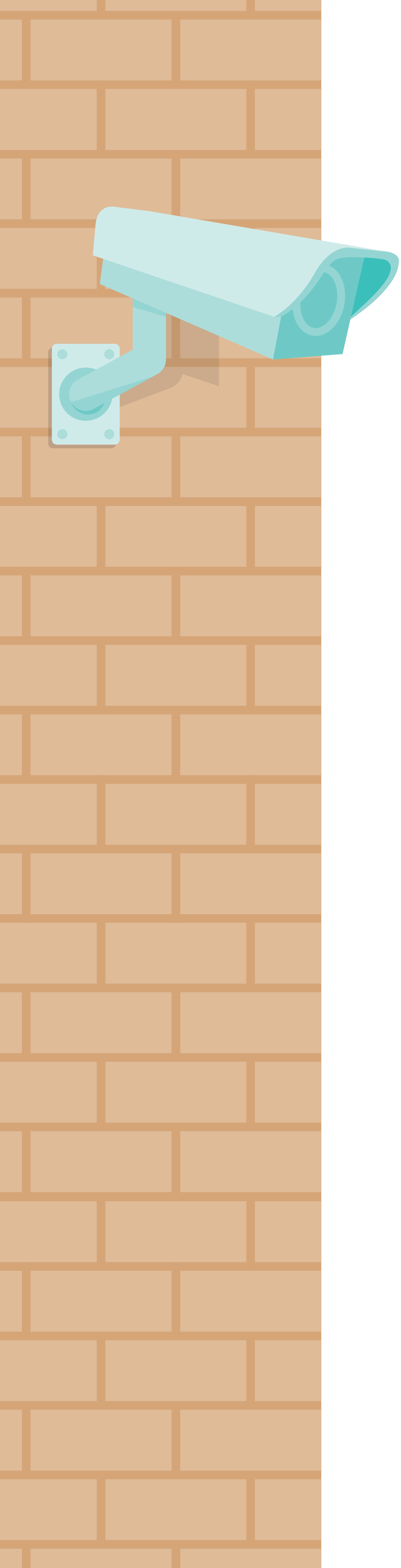
Management of liquidity risk comes under the microscope

The SEC is also becoming more prescriptive about liquidity. Its consultation paper, launched in September 2015, suggests that **US** investment managers should boost liquidity buffers in mutual funds and ETFs via pools of cash and assets that can be liquidated within three days, and it proposes that illiquid assets should be limited to 15 percent of a fund. Clearly, these measures could impact a fund's ability to track, or beat, its benchmark.

The paper also suggests that funds should be subject to "swing pricing". This is similar to a facility already operative in **Europe**, whereby large sales orders are subject to an exceptional discount price relative to the fund's net asset value, to ensure remaining investors do not bear the costs of liquidating fund assets, so are not harmed by the exit of other investors.

The SEC is to examine investment advisers to mutual funds, ETFs and private funds that have exposure to potentially illiquid fixed income securities. It will also examine registered broker-dealers that have become new or expanding liquidity providers in the marketplace. These examinations will include a review of various controls in these firms' expanded

> "The less transparent things are, the greater the risk of negative surprises."



business areas, such as controls over market risk management, valuation, liquidity management, trading activity and regulatory capital.

In **Canada**, the OSC in 2015 undertook a series of targeted reviews focused on liquidity assessments of fund holdings, liquidity stress testing and liquidity valuation considerations. It focused on funds that invest in asset classes that were considered to be more susceptible to liquidity concerns, including high yield debt funds, emerging market funds and small capitalization equity funds. It subsequently published guidance to fund managers including:

— Having robust policies and procedures on liquidity assessments at the time of purchase of an investment and on an on-going basis.

— Having written stress testing policies and procedures, including using scenario analysis that incorporates redemption rates that exceed past redemption experience.

— Using valuation procedures that take into account the market conditions for the portfolio asset.

Liquidity risk management is also being subjected to heightened scrutiny in the UK. Earlier in 2015, the BoE called on the UK regulator to seek more information about how investment managers are protecting investors against potential liquidity risks. The BoE was satisfied with the subsequent information-gathering, noting that funds could liquidate over one day roughly three times the average dollar corporate bond market turnover. However, it warned that the "future redemption behaviour of investors — and markets' ability to absorb the resulting asset sales by funds — may differ to that witnessed historically". Governor Mark Carney warned that investment managers may have unrealistic views of their ability to liquidate corporate bonds in times of severe market turbulence.

In a paper in November 2015 the BoE therefore argued that stress tests applied to the banking sector should be extended to funds, because funds' strategy for managing liquidity in stressed conditions could have "important consequences for the overall level of market liquidity".

The BoE also gave support to efforts by the UK's FCA to assess investor awareness of the liquidity risks associated with investment funds, to communicate the need for good liquidity management to the investment management industry and to assess leverage in investment funds.

In **Germany**, however, the industry has lobbied hard to avoid a systemic risk assessment, which it regards as potentially resource-intensive and unlikely to uncover identifiable risks. To date, BaFin has agreed and has said little publicly on the subject.

Just over the border in **Belgium**, though, the regulator has carried out stress testing and back testing on bond funds. But the industry has pointed out publicly that liquidity can vary depending on when it is measured.

The **Indian** regulator has been particularly descriptive in its focus on systemic risk. In order to provide investors with enhanced diversification benefits and put mutual funds in a better position to handle adverse credit events, it decided to revise prudential limits for sector exposure and to introduce prudential limits for group level exposure. Presently, the guidelines for sector exposure in debt-oriented mutual fund schemes impose a limit of 30 percent at the sector level and an additional exposure not exceeding 10 percent (over and above the limit of 30 percent) in the financial services sector.

In addition, SEBI has introduced mandatory monthly stress testing for liquid and money market mutual funds, to improve risk management. Risk parameters tested include interest rate, credit, and liquidity and redemption risks.

Integrity of capital markets is a must

Investment managers are also required to play their part in ensuring the integrity, transparency and stability of capital markets.

The **European** rules on market abuse have been revised and must be implemented by July 2016. The **Irish** regulator is currently reviewing the practices of firms when dealing with insider information and their compliance with Market Abuse Regulations. The review will look at what policies are in place to monitor and manage insider information and to comply with the rules.

Germany, meanwhile, is looking at "market timing". BaFin is seeking to prevent asymmetric information flows, whereby fund portfolio information is distributed to just a few groups of investors and not to the wider market, which can enable large investors to time when they come in and out of funds.

MiFID II contains additional requirements about transparency in the capital markets. For example, the current process whereby brokers report transactions to the **European** national regulators is extended, with more financial instruments covered, a significant increase in the number of pieces of data to be reported per transaction, and investment managers no longer able to rely on the broker's report. Managers must establish transaction reporting systems or, if they outsource, proper due diligence and governance processes.

The **Swiss** Financial Market Infrastructure Act has echoes in the larger trading blocks. It is similar to the US's Dodd-Frank legislation and to the European rules in that it regulates derivatives trading and describes new infrastructures and their approval processes, but its design is "lighter" than its US and European equivalents.

Although the Act was conceived after the G20 summit in 2009, the consultation phase lasted until March 2014 and it was expected to come into effect at the earliest in Q1 2016.

In **Singapore**, the MAS has consulted on a proposed regulatory framework for intermediaries dealing in over-the-counter (OTC) derivatives, taking into account the distinct characteristics of the OTC derivative market and the regulatory requirements in major financial jurisdictions. It has also consulted on draft regulations for mandatory clearing of derivative contracts and on proposals to implement margin requirements for un-cleared derivatives.

The **Japanese** regulator is taking a different tack. It is surveying the impact of algorithmic trading, including conducting a field survey on the stability and fairness of the market.

Intensification of supervisory oversight

Around the globe, regulators are increasing their supervisory and monitoring resources, both generally and specifically in relation to investment management.

The regulator in **Belgium**, for example, is considerably bulking up its oversight capabilities. It has increased its staffing levels substantially in the last three years and is now able to complete comprehensive off-site visits to investment managers. It has more than 100 staff conducting MiFID inspections alone. Its focus is also on ensuring that firms have implemented the UCITS and AIMFD regulations.

The **Dutch** financial regulator has created a new unit dedicated to investment management, in response to the fund industry's rapid growth due to the low

> "Investment managers may have unrealistic views of their ability to liquidate corporate bonds in times of severe market turbulence."

> Does the chief compliance officer report to the CEO/ CFO; is compliance considered an important partner in business or as a support function; does compliance have the resources to make checks across the whole firm's activities.

interest rate environment and the growth of market-based funding. The regulator sees this as creating new risks, which demands a more integrated approach to supervision.

In **Singapore**, MAS's approach is also becoming more active. In particular, its inspections have had increased focus around AML/CFT. And in **China**, in the light of last summer's stock market crash, the three banking, insurance and securities regulators may be merged into one super-regulator (moving in the opposite direction to South Africa — see Chapter 1).

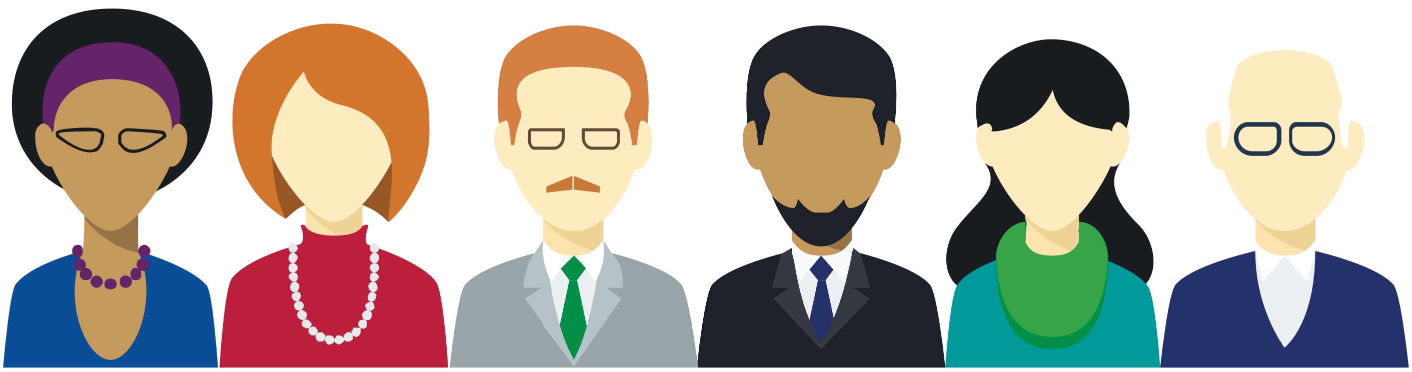
The **US** SEC has added resources with relevant industry expertise to enhance the examination focus, which is evident with the creation of the private funds unit focusing on hedge and private equity strategies. This unit looks for emerging problems, such as inherent conflicts of interest and waterfall calculations, and assesses what enforcement can be taken.

Interestingly, the SEC has augmented its data analytical capabilities through a relationship with Palantir Technologies, which was awarded a contract in September 2015 worth an estimated USD 90 million over five years. This technology will assist the SEC's ability to analyze big data and focus resources based on the analysis.

It is rare for regulators to partner with third-party service providers and may become more widespread across the globe as regulators seek to keep abreast of an ever-widening range of investment management issues. Certainly, it seems to signal a more proactive stance by the SEC. In fact, the SEC for the first time took action against a chief compliance officer in 2015 for failing to disclose a conflict of interest. This was swiftly followed by a second enforcement notice.

These instances are unlikely to be the last with Daniel Gallagher, an SEC Commissioner, saying that the SEC needed to "take a hard look" at the rules for compliance officers, which were "not a model of clarity". The SEC believes investment firms could avoid enforcement by asking themselves a few simple questions such as: does the chief compliance officer report to the CEO/CFO; is compliance considered an important partner in business or as a support function; does compliance have the resources to make checks across the whole firm's activities, and so on.

Speeches are an important mode of communication in the US in general, and by the SEC in particular, so the focus on compliance is likely to be enduring. However, the SEC is not minded to be prescriptive at the moment, preferring that investment firms think independently and act appropriately.



EIMR abbreviations

ACRA	Accounting and Corporate Regulatory Authority (Singapore)
AI	Accredited Investors
AIF	Alternative Investment Fund (EU)
AIFMD	Alternative Investment Fund Managers Directive (EU)
AIMA	Alternative Investment Management Association
AIMC	Association of Investment Management Companies (Thailand)
AMF	Autorité des Marchés Financiers (France)
AML	anti-money laundering
APRA	Australian Prudential Regulatory Authority
ARFP	Asia Region Funds Passport
ASEAN	Association of South-East Asian Nations
ASIC	Australian Securities & Investments Commission
ASISA	Association for Savings and Investment South Africa
AuM	Assets under Management
BaFIN	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)
BIS	Bank for International Settlements
BoE	Bank of England
CBI	Central Bank of Ireland
CFT	Countering the Financing of Terrorism
CMU	Capital Markets Union (EU)
CONSOB	Commissione Nazionale per le Società e la Borsa (Italy)
CSA	Canadian Securities Administrators
CSRC	China Securities Regulatory Commission
CSSF	Commission de Surveillance du Secteur Financier (Luxembourg)
CVM	Comissão de Valores Mobiliários (Brazil)
DC	Defined Contribution
EAC	Effective Annual Cost
EBA	European Banking Authority
ECB	European Central Bank
EIMR	Evolving Investment Management Regulation (KPMG International)
EFAMA	European Fund and Asset Management Association
EIOPA	European Insurance and Occupational Pensions Authority
ELTIF	European Long-Term Investment Fund
ESAs	European Supervisory Authorities
ESG	Environmental, Social and Governance
ESMA	European Securities and Markets Authority
ETF	Exchange-Traded Fund
EuSEF	European Social Entrepreneurship Fund
EuVECA	European Venture Capital Fund
FCA	Financial Conduct Authority (UK)
FINRA	Financial Industry Regulatory Authority (US)
FIP	Fondo Investimenti Piemonte (Brazil)
FoFA	Future of Financial Advice (Australia)
FSB	Financial Stability Board
FSC	Financial Services Commission (Jersey)
FSCA	Financial Sector Conduct Authority (South Africa)
GDPR	General Data Protection Regulation (EU)
G-SIFI	Global Systemically Important Financial Institutions
IFIC	Investment Funds Institute of Canada
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
InvIT	Infrastructure Investment Trust (India)
IOSCO	International Organization of Securities Commissions
ISA	Individual Savings Account (UK)
KIID	Key Investor Information Document (EU UCITS)
KYC	know-your-customer
LGPS	Local Government Pension Schemes (UK)
MAS	Monetary Authority of Singapore
MER	Management Expense Ratio
MiFID II	Revised Markets in Financial Instruments Directive (EU)
MRF	Mutual Recognition of Funds (China Mainland-Hong Kong)
NIST	National Institute of Standards and Technology (US)
NAV	Net Asset Value
NISA	Nippon Individual Savings Account (Japan)
OEIC	open-ended investment company
OSC	Ontario Securities Commission
OTC	over-the-counter
PA	Prudential Authority (South Africa)
PRIIP	Packaged Retail Investment and Insurance-based Products
KID	Key Information Document (EU PRIIP)
PVD	Provident funds (Thailand)
RAIF	Reserve Alternative Investment Fund (Luxembourg)
RDR	Retail Distribution Review (UK)
REIT	Real Estate Investment Trust
QFC	Qatar Financial Centre
SA FSB	South African Financial Stability Board
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchanges Commission
SFC	Securities and Futures Commission (Hong Kong)
SLP	Société de Libre Partenariat,
SME	Small to Medium-sized Enterprise
SPV	Special Purpose Vehicle
SRI	Socially Responsible Investment
TCF	Treating Customers Fairly
TER	Total Expense Ratio
UCITS	Undertakings for Collective Investments in Transferable Securities (EU)

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