



Evolving Investment Management Regulation

Succeeding in an uncertain landscape

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Foreword



The likely impacts and consequences of key political events in 2016 and 2017 underline that financial services regulation is not the sole prerogative of regulators. The new political context within Europe and in the US, and developments in Asia and elsewhere, are likely to have a significant influence on regulatory policy and rule-making, during 2017 and beyond. Conditions in the global capital markets will be impacted by these and other developments, including the removal or introduction of capital controls and economic sanctions. And recent cyber attacks have turned an operational risk into a political imperative.

Geo-political risks are not new for the industry. At present, though, there is heightened awareness of the direct impact that these risks are having on regulation, both prospective rules and the supervisory approach to existing requirements. The potential for unexpected policy U-turns is making firms cautious about future business plans. Politics are also influencing regulatory specifics, in the conclusions of the systemic risk debate and the approach to delegation, for example. However, the drivers for regulatory change differ from one jurisdiction to another.

It is not yet clear what impact the emerging geo-political environment will have on the trend, post-financial crisis, towards the convergence of worldwide regulatory standards. Will the trend slow, or will it even be reversed? The answer is most likely to be seen first in debates about banking and capital markets regulation, but it will soon begin to influence regulatory policy for investment management and funds, too.

Meanwhile, the industry is expected to support economic growth and is required to demonstrate its commitment to good and transparent outcomes for investors.

The role of the industry — bringing those with money to invest together with enterprises in need of funding, and supporting the savings of aging populations — is in increasing demand, as government and bank funding continues to be constrained. On the other hand, the industry 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 continue to be under the regulatory spotlight and are being made more transparent. New regulation is requiring fundamental changes to firms' business models.

Around the globe, firms are being asked to implement new rules, while they seek to achieve good investment outcomes for clients in volatile and uncertain market conditions. But it is also very important that firms keep their eye on the growing ball of further regulatory proposals. Post-crisis rules are coming up for review and there is a raft of new regulation on the horizon.

These discussions provide a number of regulatory signposts for the investment management industry, but there is also considerable uncertainty about the direction of travel in some areas. Firms will need to steer their operations around unexpected turns and address some challenging questions.

The combination of a heavy regulatory agenda and an uncertain path underlines the need for firms to remain alert throughout 2017 to intense regulatory and media scrutiny of the sector, while implementing new rules. Successful firms will challenge and adapt their financial and operational models. They will have in place efficient and effective mechanisms for the identification of, planning for and implementation of regulatory change.



Jeremy Anderson
Chairman KPMG's
Global Financial Services
practice



Tom Brown
Global Head of Investment
Management

Executive summary



Around the globe, the investment and fund management industry is in the process of **implementing** new requirements and **responding** to data requests and supervisory reviews. And more changes loom on the horizon. Some jurisdictions face a pipeline of new regulatory initiatives, and some parts of the industry are being brought into regulation for the first time. Regulatory drivers differ, but there are recurring themes.

The industry is increasingly being **challenged** about its business model, commercial relationships, costs, charges and product disclosures. Its role in and impact on the global capital markets is being **scrutinized**, across the piece but, in particular, in those areas where the industry is growing. At the same time, policy makers continue to seek the industry's support in **providing** retirement savings and **supporting** economic growth.

In the midst of this heavy regulatory agenda, perhaps the most difficult issue for firms to manage is **uncertainty**. Reviews of post-financial crisis rules – some of which have yet to bed down fully – and political events are causing nervousness about the direction of travel. Meanwhile, new technologies create new solutions and risks. Steering businesses in uncertain times requires clear leadership, good governance and agile operations.

Last year, we noted that international agencies had softened their stance on the investment management sector, moving away from designating investment firms as **systemically important**. The debate focused, instead, on systemic risk arising from the *activities* of investment managers and investment funds. That debate is now moving to the policy conclusion phase.

Global regulatory bodies have expressed the view that investment and fund management activities can be “systemically important.” Initial policy recommendations are focused on liquidity management in open-ended funds. Some national regulators are already taking action, and more data on derivatives use, leverage, liquidity and portfolio composition are being called for.

The protracted post-crisis debate on the regulation of money market funds is also drawing to a close, but questions have now arisen about the possibility of significant amendments to the US Dodd-Frank Wall Street Reform and Consumer Protection Act, a key plank of the **US** response to the G20 post-crisis regulatory agenda.

The **culture and conduct** of firms remains on the regulatory agenda. Stewardship, corporate governance and fund governance are still in regulators' cross-sights. However, there is little standardization about how corporate governance is defined and implemented, with each jurisdiction focusing on areas of concern to local investors and political classes.

There are a number of emerging themes, though, such as increasing focus on named individuals and clarity of roles, and on risk and compliance functions. Prudential requirements, outsourcing, best execution and trade allocation, and payments for investment research are occupying different regulators around the globe. In some jurisdictions, specific types of entities are in focus, including wealth managers and distributors.

Driven by political, regulator, investor and media attention, **costs and charges** now sit squarely at the top of the reform agenda in the investment and fund management industry. If there was any doubt about the importance of the issue, recent moves by international and regional regulators have removed it. Within **Europe**, for example, the implementation of MiFID II¹ will bring about fundamental changes to industry commission practices, and several other countries, too, have introduced new rules in this area.

The number of regulators scrutinizing the *level* of charges and their disclosure is increasing. Also, disclosure of the remuneration of senior management and portfolio managers continues to attract regulatory attention.

Regulators are becoming ever more granular in their scrutiny of different **types of fund**, with product types and even individual products now in their purview. In particular, some are requiring funds to be clearer about the investors they wish to target. And the alternative funds industry continues to see a trend in the regulation of products that have previously been unregulated.

On the other hand, there are moves to liberalize some products, to enable them to invest in a wider range of assets or to market them to a wider range of investors. Indeed, some jurisdictions are allowing certain types of funds to be unregulated or their managers to be subject to lighter requirements.

Climate change fund regulation is creeping forward slowly. Meanwhile, a number of jurisdictions are seeking to make further improvements to personal pensions and individual savings accounts, providing new opportunities for the industry.

The impacts of regulation on the **cross-border distribution** of funds or investment management services – whether enabling or restricting – have been carefully watched by the industry for many years. The 30-year old UCITS² cross-border passport has spread to other funds and other parts of the globe. The passporting trend has seemingly been unstoppable, a natural adjunct to the increasing globalization of financial services. However, obstacles to this trend have appeared, within both **Asia** and **Europe**.

And a much more significant obstacle looms on the close horizon, for both funds and investment management – “Brexit”. The **UK**'s decision to leave the EU is a national decision, but Brexit will

be an international event with significant regulatory ramifications, around Europe and globally.

Meanwhile, some regulators remain intent on opening up their capital markets, which should be good news for investment managers.

Innovation and automation – “**FinTech**” – are starting to disrupt and reshape the investment management industry. According to some commentators, this sector of the financial services industry is seeing the highest penetration of technology companies, highlighting the threat to traditional fund firms. Robo-advice is the subject of particular attention, but regulators are also debating the impact of new technologies on firms' back offices.

Technology can have positive impacts: it can bring efficiencies in transactions in fund units, for example, and help firms and regulators meet the increasing demands for data, including fiscal authorities' demands for information on fund investors.

However, innovation is causing regulators to question whether existing rules and supervisory approaches are fit for purpose. They add to prior concerns about **cyber-security**, money laundering and terrorist financing, especially given recent attacks.

Key questions for CEOs

- Are our culture and conduct good across all levels and all departments?
- Are we challenging our approach to costs and charges, and their disclosure?
- Are we prepared for fundamental changes to current cross-border distribution models?
- Are we prepared for increased demands from regulators for data?
- Are we keeping pace with new technologies and operational risks?
- What is our process for identifying, planning for and implementing regulatory change?

¹ Markets in Financial Instruments Directive, revised

² Undertaking for Collective Investment in Transferable Securities

Systemic risk: the regulatory end-game is close

The systemic risk debate has swung to and fro in recent years. Last year, we noted that international agencies had softened their stance on the investment management sector, moving away from designating investment firms as systemically important.

No more. The debate about systemic risk arising from the activities of investment managers and investment funds is moving to the policy conclusion phase. Global regulatory bodies have all indicated that investment and fund management activities can be “systemically important”.

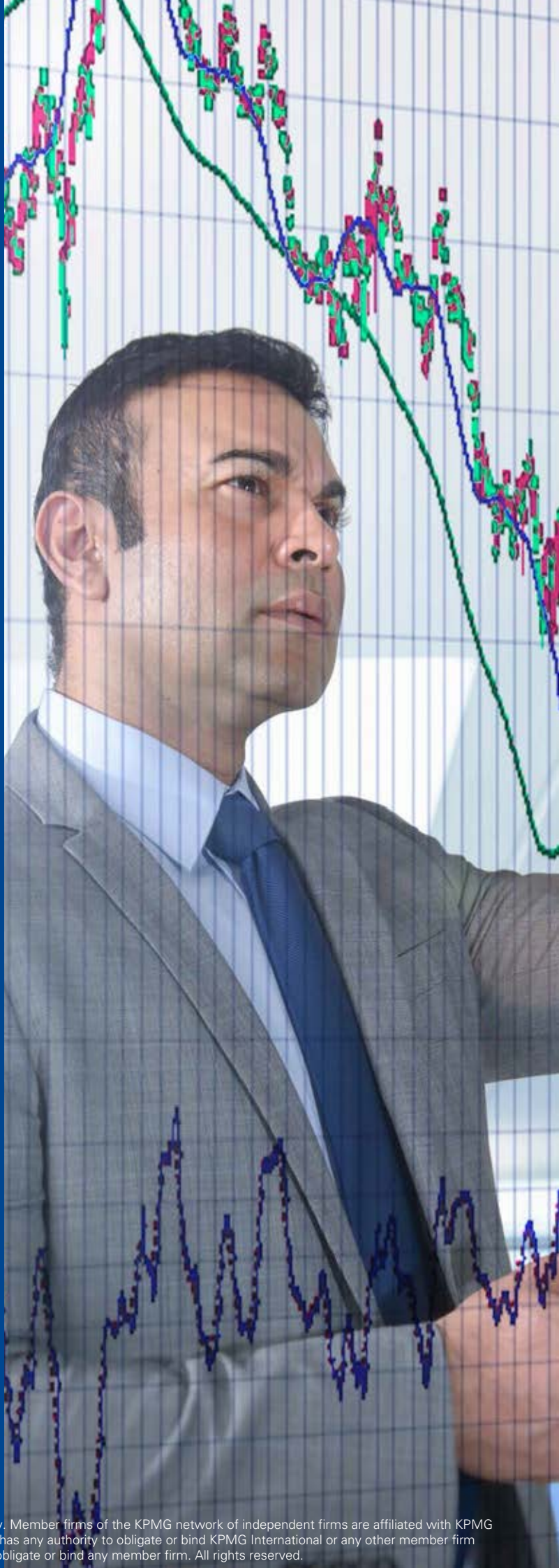
The FSB³ has gone further, issuing policy recommendations to regulators and firms, with a focus on liquidity management in open-ended funds. Some national regulators are already taking action and IOSCO⁴ has called for more data on derivatives use, leverage, liquidity and portfolio composition.

The protracted post-financial crisis debate on the regulation of MMFs⁵ is also drawing to a close, but questions have now arisen about the possibility of significant amendments to the US Dodd-Frank Act, a key plank of the US response to the G20 post-crisis regulatory agenda.

³ Financial Stability Board

⁴ International Organization of Securities Commissions

⁵ money market funds





State-of-play on systemic risk

The ECB⁶, FSB and IOSCO have all issued statements indicating that investment and fund management activities will be caught under the “systemically important” umbrella.

The ECB pronounced in mid-2016 that investment managers pose systemic risk because of their “herding” behavior and are “too big to fail”. It noted that there were vulnerabilities at “individual asset management company level”. It also argued that developments at an individual fund could have an adverse impact on the reputation of a large investment management company.

Imperfect liquidity transformation and leverage, which could amplify the effects of market shocks, are cited as the main vulnerabilities of investment funds. The “gating” of a number of real estate funds following the **UK** vote to leave the EU in June 2016 highlighted the possible domino effect that a crisis of confidence could have on funds. In particular, some in the industry worry about the pricing of bond funds in a time of turmoil, since bonds lose some of their intrinsic characteristics – such as issuer, coupon and maturity – when put into a collective fund and sold in units. In a high-redemption environment, and absent appropriate liquidity management tools, fund managers might be forced to sell short-term duration bonds and expose remaining fund investors to less-liquid and longer-term issuance.

The leverage concern is more questionable. The ECB notes that in the banking sector, assets are often 10-30 times the size of equity. Leverage is considerably lower in investment funds, with assets substantially less than twice equity. This figure may be a little

understated given that it does not in all cases take full account of synthetic exposures via derivatives, but leverage rates are still substantially lower than for banks.

The ECB further suggested that bank- or insurance-owned fund houses could present significant risks during times of market turbulence. A bank or insurance company parent “can be a direct channel of contagion between the investment fund sector and banks”, claimed the ECB. “If funds experience stress, sponsoring banks might step in and provide liquidity backstops, indemnification or credit lines, even if not contractually obliged to do so”. The European Fund and Asset Management Association (EFAMA) has vehemently countered this assessment, arguing it does not account for certain important corporate governance realities, such as the legal and operational independence between a bank or insurance parent and its investment management subsidiary.

EFAMA also argued that the ECB’s concerns on reputational risk are unjustified, noting that this risk is by definition firm-specific, so the chances of triggering an industry-wide crisis of confidence, and consequent systemic contagion, are remote.

The ECB paper did acknowledge that the UCITS Directive and the AIFMD⁷ requirements go some way towards addressing systemic issues. The ECB also praised the sector for acting as an important buffer for the real economy as bank credit contracted, and noted that it bridges information gaps and widens the distribution of risk exposures.

⁶ European Central Bank

⁷ Alternative Investment Fund Managers Directive

“ ... drive to widen and deepen the collection of data by national regulators.”

FSB goes back to the future

Before the ECB’s paper, global regulators had considered and dismissed similar concerns. However, in January 2017, the FSB re-joined the fray, issuing 14 policy recommendations to address what it describes as “structural vulnerabilities” from investment management activities.

Its re-entry into the debate was not surprising. It had indicated in 2015 that it was in favor of a systemically-important label. It adjusted its stance later that year, saying it had moved towards IOSCO’s position, which does not seek to focus on specific investment firms but on activities. Indeed, in early 2016, Mark Carney, FSB Chairman, wrote to the G20 and central bank governors, confirming that the focus was on aggregate risk rather than firm-specific risk.

However, the FSB now reasserts its earlier stance that open-ended funds are a source of systemic risk. From 2019 it will progress work on the identification of globally systemically

important financial institutions (G-SIFIs) within the investment management sector. In particular, it will address “any residual entity-based sources of systemic risk from distress or disorderly failure that cannot be effectively addressed by market-wide, activities-based policies”. In response to industry criticism of its focus on open-ended funds, it says it will also conduct further assessment of pension funds and sovereign wealth funds.

The FSB did acknowledge that open-ended funds have been generally resilient and have not created financial stability concerns in recent periods of stress, with the exception of some MMFs. It is concerned, though, that open-ended funds investing in less actively-traded assets, but offering daily redemption for investors, could amplify downward pricing of these assets and market illiquidity as a whole if many investors want to redeem simultaneously.

In line with the ECB paper, nine of the FSB’s 14 policy recommendations relate to liquidity management, covering liquidity profile data, liquidity risk management tools,



greater consistency between the underlying assets and the frequency of unit redemptions, and disclosures to investors.

Regulators are required to collect more information from fund managers and to review disclosures to investors. They are also required to make available to fund managers a range of liquidity management tools — such as swing pricing and redemption fees — and “where relevant” to consider system-wide stress testing. The FSB did not state how, in practice, this should be done.

For funds that use leverage, the recommendations cover the collection of data and the need for convergence around simple and consistent leverage measures. To address the lack of a consistent measure of leverage in the industry, the FSB suggests that IOSCO develop risk-based measures, and collect national and regional leverage data.

In relation to securities lending, the FSB recommends that authorities monitor indemnifications provided by agent lenders and investment managers, to avoid the development of material risks or regulatory arbitrage. It does note, however, that only “a very limited number” of large investment managers engage in this.

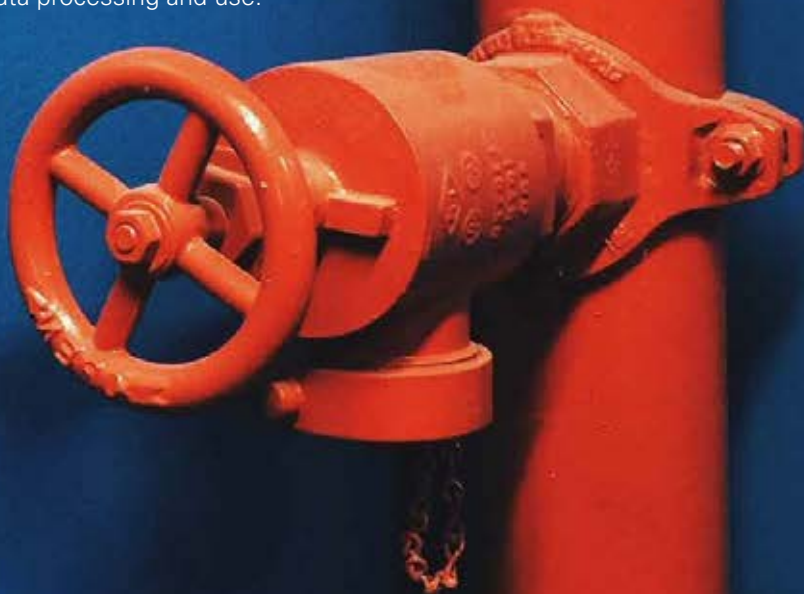
There is also a recommendation on risk management frameworks for large, complex investment managers, including business continuity and transition plans.

In some jurisdictions, regulators will need to act on all 14 recommendations and a number already are. In **Europe**, on the other hand, many of these recommendations are already in place in EU or national requirements, although a few — such as industry-wide stress testing — are new.

IOSCO launches data drive

IOSCO has already responded to the FSB recommendations. Indeed, the near-term impact for investment managers will likely come from IOSCO’s drive to widen and deepen the collection of data by national regulators.

For open-ended regulated funds, more data on derivatives, leverage, liquidity profiles and portfolio composition are sought. For separately-managed accounts, the dearth of data on leverage and derivatives has been noted. For alternative funds, consistent definitions, particularly for leverage, are a priority. The use of standardized identifiers is recommended, and regulators are asked to enhance their capacity for data processing and use.



New requirements for US mutual funds

Investment managers and fund sponsors will need to make fundamental changes to their businesses, including redesigning and implementing governance and risk management frameworks.

- All registered open-ended funds and exchange-traded funds (ETFs) must adopt a written liquidity risk management program, including classifying the fund's investments into four buckets. The new rules also prohibit investments in illiquid assets from exceeding 15 percent of total NAV⁸.
- Two new reports must be filed on a monthly and annual basis with the SEC⁹. Fund managers will need to disclose information on portfolio holdings, liquidity classification, swing pricing elections, certain risk metrics, derivatives holdings, use of repurchase agreements, controlled foreign corporations, securities lending activities, analysis of strategy/risk, flow information, and the ability to meet redemptions.
- Funds face limits on the amount of leverage they can obtain through derivatives. Depending on the extent of their usage, a fund may have to establish a formal derivatives risk management program and maintain assets equal in value to its full exposure.

IOSCO has also presented the findings of a survey of 24 member jurisdictions that it launched in December 2015 on the risks of loan origination by funds. The scope of the survey covered both loan-originating funds and funds that participate in loans from other financial institutions. It encompassed open- and closed-ended funds, and retail and professional funds.

The main risks identified are credit risks, liquidity risks, regulatory arbitrage (between banking and non-banking lenders) and systemic risks, with a general consensus that liquidity management, as well as leverage and investor protection, are the risks requiring particular attention.

One of the key conclusions is that the loan-originating fund market is relatively small and predominantly located in the **US**. There is an increasing interest in this asset class in **Europe**, though, where **Luxembourg** and the **UK** are the main players, but **Belgium, France, Germany, Ireland, Italy and Spain** also allow loan funds. (See also Chapter 4.)

IOSCO says loan funds are “shadow banking” instruments, which highlights the need for further monitoring. However, as they remain a niche market, further work is not warranted at this stage, it said.

National regulators take matters into their own hands

In **Europe**, ESMA¹⁰ has also stepped back into the debate. Investment managers will be subject to tougher scrutiny over whether they pose a systemic risk to financial markets, said the chairman of ESMA in January 2017. Steven Maijoor said ESMA would consider stress testing in the European fund industry, as recommended by the FSB. But he added that ESMA's

approach will take into account that the fund management industry is a “very different sector” to the banking industry.

Some national authorities started to implement systemic-risk related regulation in advance of any supra-national edicts. In July 2016, **France's** financial regulator (AMF¹¹) issued draft guidelines on best practice for the stress testing of funds, both UCITS and AIFs¹².

In March 2017, it released the final guide, which provides best practice examples of stress tests of market, liquidity and counterparty risk. Fund managers should implement stress tests for their entire range of funds, test vehicles at different stages of their life cycles and create procedures for warning when thresholds are reached. The guide also reminds firms that stress tests form part of the overall risk management policy, and must be updated regularly and adapted for each fund.

The AMF now allows UCITS and most AIFs to use “gates” in exceptional circumstances and if the investors' best interests so require. The gating mechanism must be described in the prospectus and, if activated, the AMF and investors must be informed.

The AMF also said it would remain “vigilant” against the liquidity risks posed by ETFs, following a study last year to identify whether increased inflows into ETFs posed potential market risks. It was concerned about the risk of divergence between the price at which an ETF trades and the NAV of the underlying securities during periods of stress. The study – believed to be the first by a national regulator in Europe – found no immediate concerns about the domestic ETF market, but that the continued growth of ETFs requires “heightened vigilance.”

⁸ Net Asset Value

⁹ Securities and Exchanges Commission

¹⁰ European Securities and Markets Authority

¹¹ Autorité des Marchés Financiers

¹² Alternative Investment Fund

The study followed a similar investigation by the SEC, which examined issues such as the implications of an ever-greater share of the **US** stock market being subject to ETF flows.

Meanwhile, the **UK's** Financial Conduct Authority (FCA) published in February 2017 a wide-ranging set of proposals to improve the way open-ended funds invested in illiquid assets cope with investor redemption demands during exceptional market conditions. The paper deals specifically with funds that invest in land, buildings, infrastructure and unlisted securities.

It stopped short of suggesting intervention to force such funds to close. "Suspensions of individual funds at their own initiative may indicate there is an orderly market where funds react appropriately to their individual circumstances," said the FCA. "A direction by the regulator to suspend some or all funds investing in a particular asset class might, however, send a signal that investors should not have confidence in that entire asset class and not just specific funds. This would risk causing the very run on funds the intervention was intended to prevent." It also says the decision to lift any suspensions "implies a judgment about an asset class that more properly sits with the manager."

In January 2017, the Central Bank of **Ireland** (CBI) hosted a conference on Non-Bank Financial Intermediation that explored issues such as investment fund risk and liquidity in Irish-domiciled funds, as well as broader topics such as mapping shadow banking in Europe. It is expected to continue its engagement with the non-bank financing and global systemic risk debates throughout 2017 and to establish a dedicated financial stability directorate.

In its themed inspections for 2017, the CBI announced it will be looking at depository oversight and the late filing of returns by regulated entities,

and conduct full-risk assessments on selected investment funds. Also, it has introduced a new "Location Rule" linked to its Probability Risk and Impact System (PRISM) rating of fund management companies. PRISM is a risk-based framework for the supervision of regulated firms, assessing the risks they pose to the economy and consumers, and mitigation of those risks. The new rule, which has been a topic of heated debate, stipulates that at least half of the management of fund management companies must be conducted by at least two persons within the European Economic Area (EEA).

The **US** SEC has introduced a series of regulations for registered funds to curb risks arising from portfolio construction, and fund and investment advisor operations. The new rules will significantly impact funds and advisors across their compliance, operations and risk management functions. The idea behind the rules is to modernize fund reporting and disclosure and to provide greater transparency to investors. In terms of systemic risk, they are designed to reduce the risk of funds not being able to meet redemption requests, minimize the impact of purchase and redemption transactions, and address risks related to derivatives.

Liquidity has become a priority issue for regulators in **Brazil**, too. The financial regulator (CVM¹³) undertook a study of fund liquidity, defining eligible securities for calculating liquid assets and creating a model that takes futures contracts into account. The measurement of a fund's liquidity is to be based on three main elements: the fund's reported portfolio composition analysis; market depth analysis; and redemption payment terms.

The regulator now believes it can better identify and monitor liquidity risk in stressed scenarios.

In **China**, the focus is more on leverage in funds. New regulation bans the launch of new principal guarantee funds, because of their leverage and because the funds are guaranteed by the investment firm's own capital, rather than within the fund. So, the risk is not ring-fenced and the firm can face significant liabilities if assets underperform.

In **Japan**, the emphasis is more generally on maintaining the soundness of the financial system. This is a response to a rise in asset prices worldwide since the financial crisis, which may not be sustainable.



¹³ Comissão de Valores Mobiliários

“ ... identifying specific risks of certain fund categories rather than trying to address the wider systemic risk question. ”

Switzerland tightens rules on derivatives

In **Switzerland**, the regulator has introduced a new law as part of the Financial Markets Infrastructure Act, which will be implemented in January 2018. It is likely to present considerable challenges in the following areas:

- group-wide calculation of open OTC¹⁴ derivatives positions (different to calculations under EMIR¹⁵)
- identification of products impacted by the Act
- process regarding counterparty classification of trading partners
- handling of discretionary mandates
- implementation of operational risk mitigation techniques via bilateral contracts or “Portfolio Reconciliation, Dispute Resolution and Disclosure” protocols
- readiness of IT systems to handle and process relevant data
- reporting of cross-border derivatives transactions
- the exchange and calculation of variation and initial margins
- amendment of internal policies and directives to reflect new duties, processes and controls
- unclear and rolling transition periods, as well as the vague wording of some provisions, may cause practical difficulties.

The regulator (JFSA¹⁶) plans to hold meetings with financial institutions based on the analysis of various stress scenarios, in order to sustain the soundness of Japan’s financial system and to maintain effective financial intermediation in case of a domestic or global economic downturn.

The **German** regulator (BaFin¹⁷) released its long-expected update to the requirements on the risk management processes of investment managers. Besides formalizing the AIFMD and UCITS requirements, the new requirements include additional guidance on the newly-introduced category of loan-originating funds.

Also expected – before the end of this legislative period, in mid-2017 – are the updated versions of German regulations on accounting and valuation, and on audit and audit reporting, for investment funds.

In common with other regulators, BaFin is discussing guidelines on liquidity risk management. Compared to some other European jurisdictions, the toolbox for managing and mitigating liquidity risks of investment funds in Germany

is limited. The discussion is heading towards identifying specific risks of certain fund categories rather than trying to address the wider systemic risk question.

Common approach required

For systemic risk mitigation to be effective, it needs joined-up thinking. This is easy to say but harder to achieve. ESMA’s 2017 Supervisory Convergence Programme puts connectedness as its priority for the coming year. It seeks a common approach to depositary functions under the UCITS Directive and AIFMD, a follow-up to the consultation on asset segregation under AIFMD, the development of a common procedure to impose leverage limits, and a connected approach to information gathering and sharing of experiences by supervisors in relation to liquidity management tools.

¹⁴ Over-the-counter

¹⁵ European Market Infrastructure Regulation

¹⁶ Japanese Financial Services Agency

¹⁷ Bundesanstalt für Finanzdienstleistungsaufsicht

Steven Maijoor, ESMA's chair, has stressed to European Parliamentarians the need for greater supervisory convergence within the **EU**. He questioned whether national regulators sufficiently assess and address the risks that their supervised entities might create in other parts of the EU. An example is the offering of contracts for difference and binary options to the retail market, which come mainly from a single Member State where firms use aggressive marketing campaigns and large call centers, he said.

The European Commission is seeking views on whether ESMA (and the two other ESAs¹⁸) should be given additional powers to increase the effectiveness of supervision. In particular, it is asking whether ESMA's governance needs to be adapted and its intervention tools enhanced.

One proposal considers handing ESMA responsibilities that currently fall under the authority of national regulators. ESMA could become a conduct authority, perhaps closer to the US model where the SEC performs the duties of a consumer protection authority.

Money market funds are finally reshaped

The long-running saga over **European** MMFs seems to have reached the end-game. It dates back to September 2013 when the European Commission published a proposal for new rules for MMFs.

The drive to create new rules came in the wake of large losses suffered by many MMF investors in 2008–09, especially in the **US**. Retail investors – and some institutional investors too – widely believed that MMFs were “safe”. This was proved not to be the case.

After years of heated debate, the MMF Regulation passed the final procedural hurdle in April 2017. But questions remain as to how some of the rules will operate in practice.

The new rules apply to both UCITS and AIFs, and to both Constant NAV (CNAV) and Variable NAV (VNAV) types. They include provisions on eligible assets, diversification requirements, prescribed liquidity ladders, disclosures to investors, an internal assessment procedure, valuation, accounting methodology and stress testing.

During political negotiations, the 3 percent capital buffer for CNAVs was first replaced with a complex set of provisions, which defined three types of permissible CNAVs: Public Debt CNAVs, Retail-only CNAVs and Low Volatility NAVs (LVNAVs). After further debate, the retail-only option was removed.

Regulators and fund managers will now have to work out how the provisions will be implemented. For example, how to deal with the exemption from the 10 percent diversification limit on deposits, the know-your-customer (KYC) requirements and reviews of internal credit assessment.

More critical for investors may be the impact of the prescriptive liquidity ladders on performance, the durability of existing investments and future product offerings. There is also concern that smaller players may be forced out of the market, resulting in a more concentrated sector.

Luxembourg, for one, has expressed such concerns about this. While the Grand Duchy backs the overall aim to regulate MMFs, it said in December 2016 that it did “not support the political agreement reached”. It said the final deal “is likely to jeopardise the viability” of some types of MMFs in the long-run and warns that it may destroy “valuable market-based sources of financing”, running counter to the objectives of the EU's Capital Markets Union (CMU) initiative.

“ ... questions remain as to how some of the rules will operate in practice. ”

¹⁸ European Supervisory Authorities

“ At a time when the new US administration is proposing a de-regulatory approach to financial services, other jurisdictions continue to progress with additional rules. ”

In particular, Luxembourg said the agreement does not fully address master-feeder funds and funds that are sold exclusively to investors outside the EU.

EFAMA welcomed the creation of LVNAVs. However, it is concerned about liquidity calculations, arguing that the lack of a principles-based approach will make it difficult to determine whether the thresholds will be workable in different market scenarios. It also lamented that lawmakers rejected the idea of MMFs operating as funds of funds.

Meanwhile, in **China**, MMF reforms have made the country's financial sector safer but risks remain, warned Fitch Ratings. MMFs are particularly vulnerable when conditions deteriorate and bond prices are volatile, said Fitch. Regulation announced in December 2015 has dampened the effect of the bond market volatility on Chinese MMFs through new rules on weighted average maturity, credit quality of

underlying assets and NAV deviation. “While these prudential regulations are a step in the right direction, they trail regulatory standards for money funds in the US and Europe,” Fitch said.

Segregation of assets: scope of European debate widens

In **Europe**, ESMA consulted at the end of 2014 on draft guidelines on asset segregation under AIFMD, offering two options. The majority of respondents strongly objected to both options, preferring other options mentioned in the cost benefit analysis.

Since then, the context of the issue has widened with the introduction of UCITS V. ESMA has launched another consultation, asking for further evidence on practices in the depository



The Dodd-Frank curveball

The US President has ordered a review of the landmark 2010 financial reform law, the Dodd-Frank Act. “We expect to be cutting a lot out of Dodd-Frank because, frankly, I have so many people, friends of mine, that have nice businesses and they can’t borrow money,” Mr. Trump said in February 2017.

There is considerable doubt though, whether the President has the support to repeal all or part of the Act. Only Congress can make substantial changes to the law, and this tends to involve lengthy and uncertain bureaucratic processes.

If the law, which prohibits financial institutions trading for their own accounts, is repealed, it would be a remarkable moment in regulatory history. Regulation has moved relentlessly forward over much of the last decade. The removal of (parts of) Dodd-Frank would represent striking regulatory retrenchment.

Indeed, Dodd-Frank was the poster child for post-financial crisis regulation. The Act imposed new oversight and authorized regulatory agencies to address systemic risk. To date, more than 200 rules have been proposed or finalized under the Act.

For investment managers, the Act initially created much anxiety – particularly over how to put into place an efficient risk management system that goes beyond compliance – and the repealing of the Act may also create considerable difficulty.

Notably, the Volcker Rule prohibited banks from proprietary trading, or sponsoring, investing and retaining an interest in funds other than US mutual funds. Many banks subsequently spun off their fund operations. Will they now seek to recreate them? What impact might this have on the non-captive investment industry, which has seen a huge flow of bank personnel to its ranks in recent years?

and custody industry. Its aim is to create a regime that ensures assets are clearly identifiable as belonging to either the UCITS or the AIF families, and that their ownership is not called into question in the event of an insolvency in the custody chain.

Both AIFMD and UCITS V include extensive provisions on the role of the depositary and, in particular, how it should safeguard the assets of a fund. The requirements on asset segregation are imposed along the entirety of the custody chain. The UCITS V requirements are slightly stricter, and some Member States, such as **Luxembourg** and the **UK**, apply them to retail AIFs.

But difficulties in achieving complete asset segregation and ownership certainty still exist. They relate to how to operate the requirements in

a global custody network and amid starkly different insolvency laws and practices across the globe. Indeed, ESMA recognizes that “a given type of segregation model intended to provide strong protection in jurisdiction X may in fact offer more, less or no change in protection if imposed on jurisdiction Y or Z”. The key question, therefore, is the optimal regime for achieving strong investor protection without imposing requirements that make it operationally impractical.

More generally, the subject of client assets is exercising some European regulators. In the **UK**, for example, the FCA is requiring thorough investigations of firms’ client asset procedures. And in **Ireland**, the CBI introduced in 2016 the Investor Money Regulations, with the objective of ensuring the protection of investor money held by fund service providers.

Meanwhile, capital markets regulation remains at the forefront

At a time when the new **US** administration is proposing a de-regulatory approach to financial services, other jurisdictions continue to progress with additional rules.

In **Europe**, MiFID II brings in a number of new requirements for capital market players (including investment managers) from January 2018, including extended transaction reporting and transparency requirements. Also, the new Securities Financing Transactions Regulation (SFTR), besides rules on issues like counterparty and collateral risks, requires funds’ annual accounts to make separate disclosures about the costs of any such transactions undertaken by the fund.

On the other hand, the EU has delayed the requirements on central clearing of OTC derivatives for smaller market players, including many investment managers, until June 2019. The reason given is that these firms are not of sufficient size to be attractive to banks as clearing clients, so they are effectively prevented from meeting the central clearing obligation.

The Monetary Authority of **Singapore** (MAS) has introduced legislation to implement OTC derivative reforms and to enhance regulatory safeguards. Also, it is consulting on improvements to the transparency requirements on the level of short selling in securities listed on Singapore’s approved exchanges.

While keeping a keen eye on progress in other jurisdictions, the JFSA is considering appropriate regulatory options for algorithmic trading in **Japan**. And in **Hong Kong**, OTC derivative reporting began in January 2017.

Scrutiny of corporate behavior is not waning

Stewardship, corporate governance and fund governance are still in regulators' cross-sights. There is little standardization about how corporate governance is defined and implemented, with each jurisdiction focusing on areas of concern to local investors and political classes.

There are a number of emerging themes, though, such as increasing focus on named individuals and clarity of roles, and on risk and compliance functions.

Prudential requirements, outsourcing, best execution and trade allocation, and payments for investment research are occupying different regulators around the globe, and some are focusing on specific types of entities, including wealth managers and distributors.

Indeed, some jurisdictions face a full pipeline of new regulatory initiatives or reviews to post-crisis rules.





Stewardship: holding investment managers to account

In **Japan**, the JFSA wants investment managers to strengthen governance and management over conflicts of interests arising from their relationships with affiliate companies. It has also amended its Stewardship Code to encourage institutional investors to engage constructively with investee companies, in the best interest of ultimate beneficiaries. The JFSA additionally demanded improved quality of disclosures by establishing a taskforce to discuss the introduction of a fair disclosure rule. The rule requires listed companies to provide non-public information to all other investors simultaneously when the information is provided to a third party.

In **India** too, the Financial Stability and Development Council will set up a committee to make rules on how institutional investors should vote on company matters. The proposed committee, comprising officials of the Securities and Exchange Board of India (SEBI), the Insurance Regulatory Development Authority of India and the Pension Fund Regulatory Development Authority, will create the Stewardship Code, similar to the guidelines adopted by the **UK**'s Financial Reporting Council in 2010.

In the **Netherlands**, a new corporate governance code came into effect in December 2016, designed to encourage long-term value creation and high-quality corporate culture within investment firms. It covers relations between the management and supervisory boards and the shareholders. It is prescriptive in areas such as appointment periods, board composition, independence and reporting.

Culture and governance of managers is tightened

In the **UK**, the FCA has published two papers on behavior and compliance for regulated firms. The first paper – “Behaviour and Compliance in Organisations” – draws on behavioral economics to argue that firms’ compliance can be incentivized and reinforced by:

- imposing more “salient and vivid” punishments for wrongdoing, especially on individuals
- introducing a stronger sense of individual morality and responsibility in decision-making, for example, through the UK’s Senior Management Regime and by requiring staff to sign up to a moral code
- stronger leadership based on a positive culture, with effective challenge of poor behaviors and a properly aligned remuneration structure.

The second paper – “Incentivising Compliance with Financial Regulation” – asks whether financial regulation can learn from fiscal authority initiatives to tackle tax avoidance.

The papers, published in December 2016, are not binding or even to be regarded as guidelines. But as an insight into the thinking of the FCA, they should be considered seriously by investment firms.

In **Malta**, the focus is more generally on ensuring proper governance of all licensed entities – that this is conducted seriously and reviewed in relation to the needs of the business. Substance is also being given importance. Similarly, **Luxembourg**'s main focus is currently governance, substance and the monitoring of delegates.

“ ... a stronger sense of individual morality and responsibility in decision-making. ”

In **South Africa**, the aim is to improve the oversight of conduct through the forthcoming Twin Peaks model. South Africa currently has multiple regulatory authorities that regulate and supervise financial institutions on a sector-specific basis. There will soon be two primary regulators – a prudential regulator and a new market conduct regulator (the FSCA¹⁹). The FSCA, due to begin operating in April 2018, will supervise the conduct of business of financial institutions and the integrity of the financial market.

In **Switzerland**, the draft Financial Institutions Act – which will enter into force in 2018 at the earliest – defines a differentiated supervisory regime for portfolio managers, asset managers of investment funds, fund management companies and securities firms. Existing provisions from other legal acts are being combined into a single law. The main change concerns the introduction of a prudential supervisory requirement for managers of individual client assets. This will have a significant impact on Swiss managers of separately-managed client accounts, which have not been subject to prudential supervision so far.

In **Singapore**, MAS issued Guidelines on Outsourcing in July 2016, with financial institutions expected to conduct self-assessments of their compliance with the guidelines within three months, and to rectify any deficiencies by July 2017. The guidelines, which are applicable to market intermediaries (e.g. fund managers), banks and insurers, are wide-reaching. For example, they include activities performed by other group entities such as head office or shared service centers.

MAS indicated that a Notice on Outsourcing may be issued at a later date. The Notice will define a set of minimum standards for outsourcing management, which will be legally binding on financial institutions.

Fund governance receives special attention

In **Brazil**, wide-ranging corporate governance changes have been enacted. The CVM says that investment management, fiduciary administration, compliance, risk management and shares distribution all require the designation of specific directors. There are, additionally, rules for responsibility of outsourcing of custody services, pricing handbooks, and the segregation of management and administration areas.

New firm-wide requirements demand:

- disclosure of periodical information on the fund manager's website
- improvements to the rules of conduct
- publication of risk policies
- improvement of internal controls
- authorization for fund managers to distribute their own funds.

Investment managers must now create a formal risk management policy that clarifies the risk exposure limit. One of its effects is to increase the risk evaluation scope, including credit and operational risks, besides market and liquidity risks.

Also mandated is the collection of evidence of dynamic regulatory compliance. Routines and procedures must be defined, and regular tests carried out to evaluate that practices meet the standard.

In **Ireland**, the CBI has concluded its work on Fund Management Company Effectiveness, which has resulted in a number of rule changes regarding managerial functions, the location of directors and designated persons, and record keeping, under both AIFMD and the UCITS Directive. Guidance was

¹⁹ Financial Sector Conduct Authority

also produced on delegate oversight, organizational effectiveness and directors' time commitments.

The CBI has set out three tenets of effectiveness: governance, compliance and supervisability. It said that strength in these areas can better protect investors. It emphasized that fund management company board meeting minutes are a key way of demonstrating compliance with these principles. Fund management companies also need to have a records retention policy, which is subject to audit and which ensures records are immediately retrievable on request. Documentation requested before 1pm should be provided on the same day and documentation requested after 1pm should be provided before noon on the following day. In order to speed up responses from fund management companies to information requests from the CBI, the guidance requires companies to set up a dedicated email address by June 2017.

The **Hong Kong** regulator, the SFC²⁰, continues to get more interventionist on fund management corporate governance issues. The Manager in Charge regime resembles the Senior Manager Regime in the UK, where individuals are identified and held accountable for governance over the long term. The SFC expanded the remit from corporates to individuals in later revisions of the regime. The deadline for submissions to the SFC is July 2017.

Deficiencies revealed in best execution

Although best execution is often seen as a technical or "plumbing" issue, it can have a material impact on trading costs and, therefore, on investor outcomes. The requirements on firms to obtain best execution for orders are again under scrutiny at the global and

European level. Both IOSCO and ESMA issued papers on best execution at the end of 2016.

IOSCO, in its ongoing effort to protect investors, is consulting on order routing incentives. Its paper examines the regulatory conduct requirements for firms to manage conflicts of interests associated with routing orders and obtaining best execution. It does not at this stage propose any next steps, so the paper is, for now, just a useful summary of current requirements and a request for additional views.

Meanwhile, ESMA said that implementation of best execution provisions, and the level of convergence of supervisory practices by national regulators, were relatively low, with 15 regulators not applying or only partly applying criteria considered essential for best execution. A subsequent review by ESMA, issued at the end of 2016, assessed whether regulators have addressed the deficiencies. There were, said ESMA, clear improvements.



²⁰ Securities and Futures Commission

“ The implementation of MiFID II will provide a further opportunity for all NCAs, in conjunction with ESMA, to converge supervisory approaches. ”

- several national regulators (NCAs) indicated they had introduced or reinforced risk-based supervision of best execution.
- several NCAs reported directly targeting best execution through thematic work, in the form of desk-based reviews or on-site visits.
- five NCAs had taken action to address previously identified deficiencies.

Among the NCAs that showed no progress, some indicated that the first ESMA report had not been considered fully. Others provided reasons similar to those expressed in 2015, such as internal organizational issues or specificities of national markets that result in potential breaches of best execution being considered low risk.

The implementation of MiFID II will provide a further opportunity for all NCAs, in conjunction with ESMA, to converge supervisory approaches.

Payment for investment research exercises regulators and firms

IOSCO’s paper on order routing incentives notes that **Canada** alone applies specific regulations to address the provision of additional goods and services alongside order execution, but that a number of national regulators apply rules to the recipients of bundled services such as “soft dollars.” Such bundling is prevalent for research and corporate access. It notes, however, the imminent changes to rules in the **EU** under MiFID II, and also in **Hong Kong** and the **US**.

Within Europe, the new MiFID II rules on payment for investment research are causing both investment banks and investment managers concern about their ability to implement new operating models by end-2017.

KPMG’s regulatory readiness approach

Requirements analysis	Current state assessment	Gap analysis and document reviews	Solution design/target state model	Implementation
<ul style="list-style-type: none"> • Rule identification and interpretation • Scope of data requirements • Disclosure requirements • Identify sources of data and other needed information • Develop traceability matrix. 	<ul style="list-style-type: none"> • Compare rule requirements against current state model • Assess service provider arrangements • Review current state policies and procedures • Identify current state technology capabilities against requirements. 	<ul style="list-style-type: none"> • Identify gaps in current state against rule requirements • Risk assess and prioritize gaps • Identify tactical versus transformational changes needed. 	<ul style="list-style-type: none"> • Solution design based on results of gap assessment • Policy and procedures development • Enhanced data integration/aggregation needs • External systems needs and/or service provider solutions. 	<ul style="list-style-type: none"> • Develop implementation plan • Test proposed solutions • Training.

Managers must identify the cost of investment research separately from order execution costs, which will require detailed information from investment banks. The costs must be met either by the manager or out of a research payment account, the funding of which has been agreed in advance with each client.

US wealth managers feel the heat

In the **US**, the governance of the wealth management industry is under intense scrutiny. Because of its dramatic growth over the past several years, and some high-profile compliance violations, the wealth management industry has come under increasing attention by the SEC, FINRA²¹ and the Department of Labor.

Wealth management firms must now carefully review their compliance departments, including governance, policies and procedures, which have drawn the most regulatory scrutiny.

There is also a growing trend in the US of financial advisors acting as portfolio managers and directly handling clients' assets, creating or accessing model portfolios, and making investment decisions on behalf of clients. Regulatory agencies are closely watching this trend, scrutinizing advisors' investment decisions to ensure they match a client's investment objectives. The SEC is increasingly holding wealth management firms' discretionary programs to the same standards as institutional investment managers. FINRA examiners recently charged several wealth management firms with failing to supervise their advisors and violating their fiduciary duties to clients.

The SEC is additionally looking at whether branch offices of advisors are as well-governed as main offices. The Office of Compliance Inspections and Examinations (OCIE) introduced a Multi-Branch Advisor Initiative as part of its examination priorities for 2017. While

branch office reviews were included in last year's examination priorities, it appears OCIE will increase its focus on the area in 2017. OCIE released a Risk Alert in December 2016 outlining the Multi-Branch Advisor Initiative, which indicated the initiative will focus on registered investment advisors that provide advisory services from multiple locations.

The US Department of Labor, meanwhile, delayed the implementation of the Fiduciary Rule from 10 April to 9 June 2017. The rule 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.

Domestic sales practices also in focus

In **Mexico**, the regulator has implemented the regulation of independent investment advisors as part of sales practice regulation. Advisors were not previously regulated but now need to be registered and comply with all sales regulation.

In **Singapore**, changes were made to regulations around the conduct for marketing and distribution activities, with effect from 1 April 2017. Some of the enhanced requirements include:

- conducting call-backs or surveys of customers prospected, to ensure they have understood their purchases
- separately tracking and monitoring complaints arising from marketing, sales and advisory activities
- maintaining information on their marketing and distribution arrangements
- ensuring that their representatives disclose and explain to customers the relationship between the financial institution and any third-party product providers

“ ... the governance of the wealth management industry is under intense scrutiny. ”



²¹ Financial Industry Regulatory Authority

“ The many pieces of post-financial crisis legislation include review clauses, a number of which are timed to take place during the next three years. ”

- ensuring that remuneration of representatives does not lead to aggressive sales tactics and other inappropriate conduct
- ensuring that any gifts offered to customers do not unduly influence purchase decisions.

In **China**, new regulations stipulate that fund distribution can be carried out only by qualified, approved distributors. This activity cannot be outsourced. Between 200 and 300 distributors had been awarded a license by early 2017. Organizations without a license have been told to cease operations.

In **Spain**, the CNMV²² published details about what type of information local fund managers need to issue to investors for all their products. The regulator said in June 2016 that having analyzed the information that funds provide to investors in Spain, it had decided to tighten the disclosure guidelines. Details on relevant markets have to be relevant to each investment product, with fund managers also having to explain any changes they make to clients' portfolios.

Then, in January 2017, the CNMV issued technical guidance aimed at improving investor protection by making the distribution of funds with a guaranteed or defined long-term return target more transparent. It said that, due to low interest rates, Spanish fund managers have significantly extended the terms of guaranteed funds, a popular product type in Spain, as well as those for products with a specific return target.

As a result, 73 percent of guaranteed funds launched in 2016 have a term of more than six years. Back in 2012, no newly-launched guaranteed fund had a term this long. The CNMV has issued binding technical guidance to ensure retail investors understand the product.

In **India**, SEBI guidelines propose that the advice function should be separate from distribution. If distributors wish also to provide financial advice, they must register as investment advisors in the next three years.

In **France**, on the other hand, it is now possible to test investors' appetite prior

to a fund launch, without falling under the marketing rules. Provided there are 50 professional investors or investors initially investing a minimum amount of EUR100,000, no subscription form or documentation relating to the fund's final features are required.

New EU rules, and more to come

In **Europe**, the implementation of MiFID II by January 2018 is absorbing significant senior management time, as well as people and systems resources of both firms and regulators.

In **Cyprus**, for example, the Cyprus Securities and Exchange Commission has employed a significant number of staff to deal with MiFID II implementation and has issued various guidelines and circulars. The regulator has become more proactive in the last two years – including improving its compliance and registration process – and is now accelerating its response to MiFID II.

Similarly, in **Belgium**, the regulator has bulked up its MiFID compliance capabilities, employing some 15 teams for inspections. The inspections, which are becoming more frequent and more detailed, and can take place at short notice, are currently focused on best execution. The resulting reports are often written in considerable detail and are accompanied by recommendations and, even, injunctions. Financial penalties are likely to be imposed as the regulatory stance in Belgium becomes more aggressive.

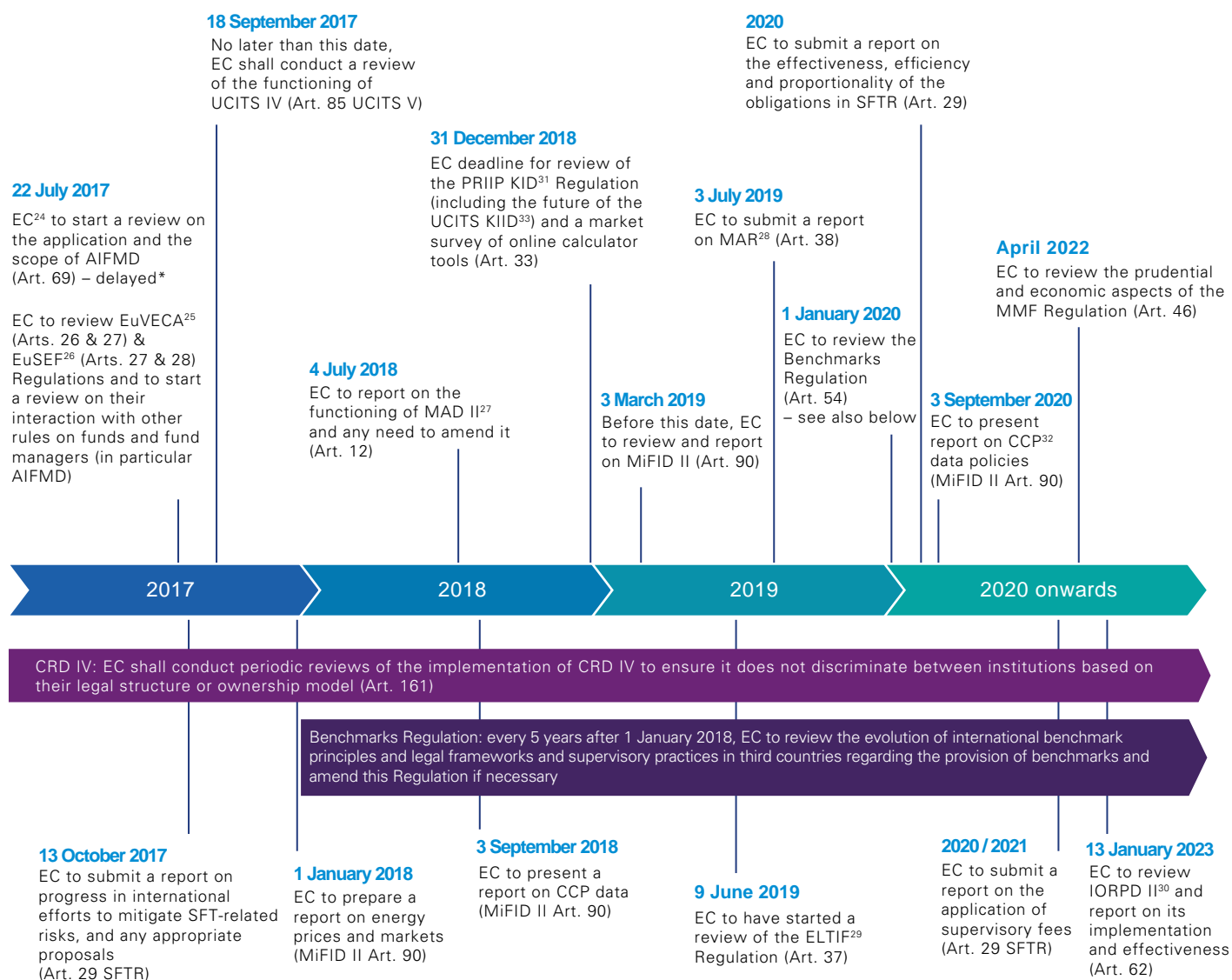
Firms must have an eye to the growing pipeline of other legislative changes, too. The many pieces of post-financial crisis legislation include review clauses, a number of which are timed to take place during the next three years. A review of CRD IV²³, for example, is already underway, although the planned review of AIFMD has been delayed.

Meanwhile, regulators are focusing on compliance with existing rules.

²² Comisión Nacional del Mercado de Valores

²³ Capital Requirements Directive, revised

EU regulation – review timeline



Silent on review date: Shareholder Rights Directive

* The EC has decided to commission a lengthy study. It will review the results and may not consult until 2018. No concrete decisions have been taken on which aspects to target. They are awaiting other Commission work on remuneration and leverage. They will deal with cross-border issues under CMU and not within this review package.

²⁴ European Commission

²⁵ European Venture Capital Fund

²⁶ European Social Entrepreneurship Fund

²⁷ Market Abuse Directive, revised

²⁸ Market Abuse Regulation

²⁹ European Long-Term Investment Fund

³⁰ Institutions for Occupational Retirement Provision Directive, revised

³¹ Packaged Retail Investment and Insurance-based Products, Key Information Document

³² Central Counterparties

³³ Key Investor Information Document

Costs and charges: regulators move into top gear

Driven by political, regulator, investor and media attention, costs and charges now sit squarely at the top of the reform agenda in the investment and fund management industry. If there was any doubt about the importance of the issue, recent moves by IOSCO and ESMA have removed it.

Within **Europe**, the implementation of MiFID II will bring about fundamental changes to industry commission practices, and a number of other countries, too, have introduced new rules in this area.

A number of regulators continue to scrutinize the level of charges and their disclosure. "Closet tracking" remains under the spotlight and the UK, for example, is applying more intensive scrutiny to the level of charges for "active" fund management.

Disclosure of the remuneration of senior management and portfolio managers continues to attract regulatory attention.





IOSCO guidance likely to be seen as cast in stone

IOSCO's Investment Management Committee in August 2016 provided good-practice guidance for fees and expenses of collective investment schemes (CIS). The guidance is not intended to form comprehensive requirements or to impose obligations on national regulators, but both regulators and firms increasingly regard IOSCO's output as setting the "pass" mark for good operational behavior.

The guidance covers regulated open-ended funds, and closed-ended funds whose shares are traded on a regulated market, and both fees paid directly by investors to the CIS operator or its agent or associate, and fees or expenses paid out of fund assets.

IOSCO describes the latter as falling into four broad categories:

1. Remuneration of the manager, including the method of calculation of performance fees
2. Distribution costs
3. Other fund operating expenses, such as custody, fund accounting or administration costs
4. Transaction costs associated with purchases and sales of portfolio assets, including securities lending and repo and reverse repo transactions.

The report makes no observations on regulatory or other expenses that may be paid out of fund assets.

Many of the good practices focus on disclosure to investors. Information should be disclosed to both prospective and current investors in a way that allows them to make informed decisions about whether they wish to invest in a CIS and accept the costs of doing so.

The report includes a section on the calculation and disclosure of transaction costs. IOSCO notes the industry

consensus that explicit transaction costs should be determined accurately after the transaction. There is less agreement on whether implicit costs can be measured retrospectively. Estimating transaction costs in advance is even more prone to variation. There is a risk that predictions of costs could turn out to be so inaccurate as to be misleading, and even illegal in some jurisdictions.

These statements are in sharp contrast to the EU's rules for the PRIIP KID on the calculation of future transaction costs for funds.

Efficiency and transparency – ESMA sets the tone

ESMA has signaled it is ready to act. It believes more can be done to improve the efficiency and transparency of the investment fund sector and is working to improve the information available to investors.

ESMA Chair, Steven Maijoor, speaking in November 2016 at EFAMA's Investment Management Forum, highlighted that ESMA is committed to building on regulatory and technology initiatives to achieve better outcomes for investors.

ESMA says improving the information available to investors will help them choose funds that offer them value for money. MiFID II requires information about third-party payments to be provided to clients. This would show investors what they indirectly pay for the services they receive, allow them to understand the total costs and be able to compare between different services and financial instruments. Additionally, ESMA believes a stronger focus on cost disclosure and inducements should lead to more competition among service providers and, potentially, reduce fees.

“ ... retail investors are not enjoying the lower fees charged to professional clients for similar products. ”

This focus on costs and charges builds on a speech earlier in the year by Mr. Maijoor. In June 2016, he said fund managers should bring down charges on retail funds to align them more closely with fees levied on institutional investors.

According to Fitz Partners, a research firm specializing in fund charges, the divergence of fees charged to retail and institutional investors is seen in both active-managed and index-tracking products. For instance, the average ongoing charge for an institutional cross-border equity fund is 0.98 percent, compared with 1.92 percent for the retail share class. Similarly, a retail investor purchasing an index tracker will pay an average 0.43 percent, compared with just 0.27 percent for institutional clients.

Mr. Maijoor said that despite “big demand” for cheaper investment products, European retail investors are not enjoying the lower fees charged to professional clients for similar products. “We know that the costs of asset management products in Europe on average are higher than in the US,” he said. “Some of that relates to scale.”

The European Commission has signaled it is ready to back ESMA. In February 2017, it launched a study of European fund fees and investment performance. Sven Gentner, head of the Commission’s Asset Management Unit, said it is “keen to advance the policy agenda” on fees. The study’s findings, which will be published by the end of 2017, will “inform policy decisions,” he said. European investors should be able to compare investment products easily but there is evidence “this is not the case.”

Payments to distributors – a global issue

In Europe, MiFID II bans commissions paid to independent financial advisors and wealth managers, while payments to other parties must pass a “quality enhancement” test of the service received by the client. However, as we noted last year, implementation is likely to be patchy at first. Indeed, we see differences in approaches already.

In **Sweden** and **Denmark**, for instance, the regulators considered a wider ban on inducements paid to advisors to retail clients, which would have stopped banks from accepting payments from third-party investment managers. This would go further than MiFID II by extending the prohibition against accepting benefits from third parties to cover all advisory services, regardless of whether they are independent, as is already the case in the **UK** and the **Netherlands**. However, neither Sweden nor Denmark proceeded with a fuller ban.

The long lead-time (seven years and counting) for the creation and implementing of MiFID II has given regulators elsewhere plenty of time to consider the implications for their own jurisdictions. In many cases, they have decided on a similar path, albeit with slightly different approaches.

In **Switzerland**, the Swiss Financial Services Act – which will come into force in 2018 at the earliest – includes rules on suitability and appropriateness when providing investment advice or portfolio management, information, documentation, accountability, transparency and due diligence for client orders.

In **Japan**, draft “Principles for Customer-Oriented Business Conduct” were published by the Working Group on Financial Markets in December 2016. The principles were conceived after it was discovered that fund managers and distribution agents colluded to hide excess returns from a fund-based insurance product. As a result, many ordinary investors – many of them elderly – were deprived of their rightful returns.

The seven principles are:

1. Formulate and publish policy on customer-oriented investment management and intermediation
2. Pursue the best interest of customers
3. Appropriately manage conflicts of interests
4. Clarify commission fees
5. Provide easily-understandable key information
6. Provide services that are suitable for the specific customer
7. Design an appropriate motivation framework for employees

As in **Germany**, where similar regulation was enacted a decade ago, the impact on Swiss investment management is likely to be considerable. In Germany, the number of managers shrank to 10 percent of the original due to consolidation.

The rules may impact foreign investment managers. Until now, the Swiss regime for managers of separate accounts (as opposed to investment funds) has been very liberal in terms of company registration and distribution of services. However, there could be a twist in the tail. With one eye on

Brexit, Swiss politicians are wondering if MiFID II-style regulation is the right way to go, given that the EU is less receptive to granting market access to third countries. It is just possible that Switzerland may look more to serving other markets than the EU.

In **Canada**, driven by investor protection and market efficiency concerns, the Canadian Securities Administrators (CSA) issued a staff notice in June 2016 proposing significant changes to mutual fund fees. The notice focuses on discontinuing embedded commissions (sales and trailing commissions) paid to dealers and their representatives. There is also a ‘best interest’ standard for advisors, dealers and representatives.

In the **US**, the SEC and Treasury Department have identified issues with the sales practices of certain wealth management firms, specifically their incentive compensation structures. Because of their bonus and compensation structure, financial advisors were incentivized to steer clients to in-house mutual funds and other proprietary investment products rather than external products that may have been more suitable for the investors.

The heightened scrutiny of sales practices has prompted some private banks and other wealth management firms to revise their policies and procedures relating to potential conflicts of interest regarding their disclosure and compensation policies.

In **India**, with effect from October 2016, fund investors must be made aware of the amount of commissions paid to distributors out of the total ongoing charges of the fund. SEBI has also instructed fund managers to show an illustration of the effect of the total ongoing charges on returns and is urging managers to adopt industry guidelines on capping at 1 percent the amount of initial commission paid to distributors.

In a separate move, SEBI is pushing managers to merge funds with similar investment strategies in an effort to halve the number of funds offered by domestic managers, and so improve costs and operational efficiencies.

Simple and meaningful cost disclosures remain elusive

In October 2016, the **South African** regulator launched a “meaningful cost comparison across investment products,” allowing consumers and advisors to compare charges and their impact on investment returns across most savings and investment products. All members of the Association for Savings and Investment South Africa are required to adopt a standard on Effective Annual Cost.

In **Europe**, MiFID II includes requirements for distributors to provide to their clients the total cost of ownership: aggregate figures for the costs of investing, both within the product and along the distribution chain. The Directive also requires portfolio managers to provide their clients with the total costs of the service they receive. The detailed rules underpinning these requirements are proving contentious, not least as regards the methodology for calculating the underlying transaction costs within a fund.

It is not the only bone of contention for the industry. In October 2016, the European Parliament rejected the Regulatory Technical Standards (RTS) essential for the functioning of the PRIIP KID. As a result, the Commission announced a delay of one year to the implementation deadline while it amended the rules on the performance scenarios methodology, the use of the fourth (“market stress”) scenario, the comprehension alert

and Multiple Option PRIIPs. The date for implementation is now in line with the revised deadline for MiFID II of January 2018.

However, the hope of a full year for product manufacturers to develop, test and produce thousands of KIDs has again been dashed. In another twist, in January 2017, the ESAs said they did not agree with the proposed revisions. After further debate, the Commission took over the lead and issued revised RTS, which were accepted by Parliament and Council, and published as final in April 2017.

The new RTS do not, though, include changes to the methodology for computing costs or their presentation. The fund management industry has consistently expressed concerns that the presentation of costs could mislead investors into thinking they are less than they are and that the methodology for transaction costs will often give rise to negative or overly-inflated, and therefore misleading, figures.

Meanwhile, many question whether the document will be used by investors. The two-page UCITS KIID, introduced in 2012 with the arrival of UCITS IV, describes a fund's objectives and investment policy, risk and reward profile, charges and past performance. However, representations to the Commission suggest that the document is not regarded by investors as useful.

Germany's fund trade body, the BVI³⁴, said in January 2017 that one reason the document has failed is because the synthetic risk and reward indicator, which has a one to seven scale for a fund's risk, is unreliable. The BVI said "it remains to be seen" whether the PRIIP KID will fare any better.

The **UK** regulator, in its interim report on its study of the investment management sector, also pointed to a low level of investor engagement with the KIID. It said only 25 percent of non-advised retail investors look at the KIID when choosing a fund.

And in the **Netherlands**, the Dutch Investors' Forum said its own research found that less than half of retail investors use the document.

Closet trackers: regulators name and shame

In last year's report (EIMR 2016), we forecast that closet index tracking was shaping up to be one of the hottest European regulatory topics of the year and could have significant reputational repercussions for the fund industry. And so it proved.

The debate, already live in many jurisdictions, heated up substantially after ESMA analysis in 2016 found that between 5 percent and 15 percent of UCITS equity funds could potentially be closet trackers – funds that charge an active fee but do little more than hug a benchmark. ESMA suggested that further investigation be conducted by national regulators.



³⁴ Bundesverband Investment und Asset Management

EU spotlight on “closet trackers”



“ ... room for improvement regarding the information provided to investors. ”

Perhaps the strongest reaction to ESMA's report has been seen in **Norway**, where the regulator publicly reprimanded a firm. Most other regulators have been reluctant to single out individual firms.

Sweden joined its Nordic neighbor by announcing in January 2017 that it had identified more than ten fund managers that offer funds with a low active share (below 60 percent). However, it stopped short of accusing them of being “closet trackers”. It, too, named the firms.

Sweden later proposed legislative amendments to tighten disclosure requirements for fund managers, following a high-level inquiry into closet index funds. The government will put forward proposals before elections in 2018 for fund managers to “declare how active or passive [their funds] are”. However, the Ministry said it would still be up to the consumer to decide if the fund fee was appropriate.

Funds in **Germany** will be forced to adopt new transparency rules after an inquiry found that some active funds “closely” track their index. The investigation into closet indexing, initiated by BaFin in April 2016, looked at 290 funds, each with assets of more than EUR10 million and each with more than half of their holdings in equities.

BaFin said there was no evidence that any active funds in Germany “solely” track an index, but it did identify active funds that “closely” follow their benchmark. However, these funds tended to have “significantly lower management fees than is normal for actively-managed funds”. In addition, the funds are no longer marketed, according to BaFin.

The regulator sees no reason to intervene on this basis, but did say there was room for improvement regarding the information provided to investors. It plans to introduce new transparency requirements for investment funds

that have more than half their assets in equities. From the middle of 2017, German funds are required to explain explicitly to investors whether they are actively-managed or track an index. Fund prospectuses will have to include the fund's long-term performance in relation to its benchmark.

Meanwhile, in **Italy**, the financial regulator announced in January 2017 that "remedial action" had been taken against some of the 10 largest fund houses it investigated over the issue. The regulator did not name the fund managers, but said it had forced them to alter their fund documentation to ensure the investment policy was consistent with the actual management.

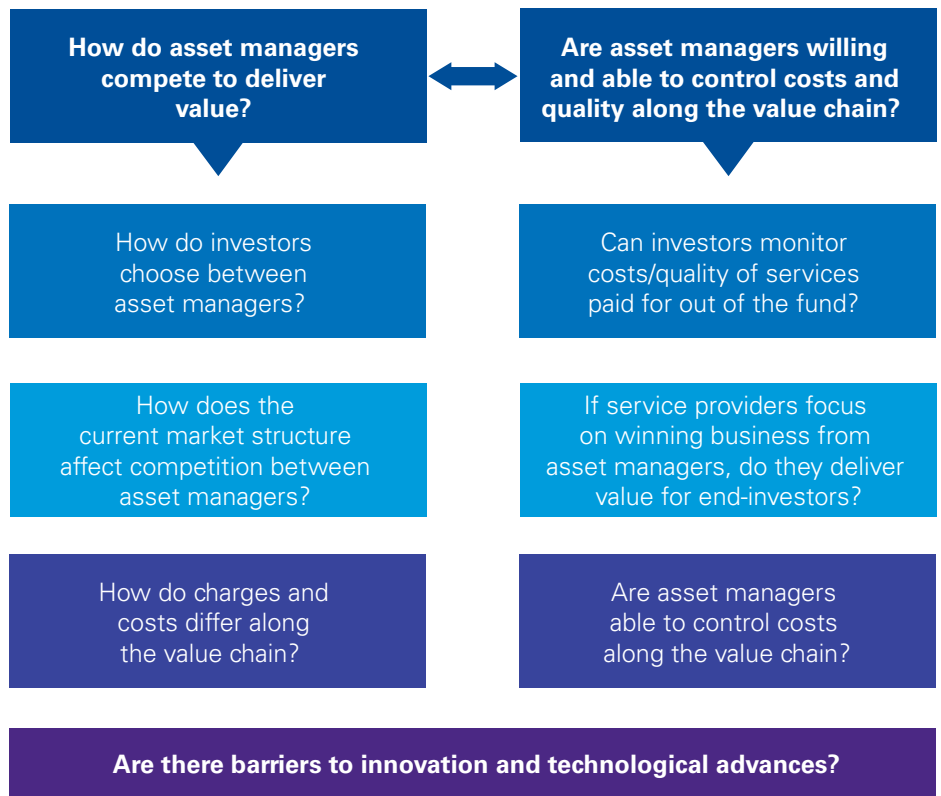
Closet-tracking identification methodologies under the microscope

The methodology – or lack of it – for identifying closet tracking funds has been questioned by the industry and some regulators.

EFAMA, for one, argues that relying on active share and tracking error to determine whether a fund is a closet tracker is misleading. Small-cap funds, funds with small assets under management and products with a diversified benchmark are all more likely to have higher active share, says EFAMA, making it easier for these funds to demonstrate active share higher than 60 percent. This compares with large-cap funds or, say, funds benchmarked to single-country markets, in which a few companies represent a large part of the index. A fund's active share can also fall in stressed markets as fund managers reduce the size of their active bets.

EFAMA also disagrees with the view that funds with an active share of less than 60 percent should automatically be

Key questions in the UK Asset Management Study



classified as closet trackers. If national regulators do use a methodology based on active share, EFAMA believes fund-by-fund analysis, including other quantitative and qualitative dimensions, should also be employed.

France's financial regulator has also criticized the methodology. The AMF said that based on its own analysis of the funds identified by ESMA as potential closet trackers, there were no French closet trackers.

Meanwhile, campaign group Better Finance disclosed the names of 62 funds with "high potential" of being closet indexers. Of these 62 funds, Better Finance said "many" do not disclose their benchmark's performance alongside their own performance in their KIID. This makes it impossible for the retail investor to assess whether and by how much a fund is hugging its benchmark. Better Finance has referred its findings to ESMA, which said it would raise the issue with national regulators.

Level of fund management fees under scrutiny

The regulatory debate on the level of fund management fees is widening. In December 2016, the wide-ranging interim report of the **UK** FCA's Competition Division's review of the UK asset management industry was tough-talking. It included a number of damning findings and proposed a series of "remedies"

The report said that active funds rarely outperform and are guilty of "considerable price clustering". It was also critical of the industry's failure to promote passive products to retail investors. Its stance would appear to indicate an endorsement, intended or not, for passive products. The regulator seems to suggest that active funds are appropriate only if there is no passive vehicle that can offer similar exposure.

Key FCA findings from the Asset Management Market Study

- Weak price competition, despite a large number of investment and fund management firms. But competitive pressures are building in some parts of the market.
- Cost control is mixed – good where straightforward to manage and inexpensive to control (e.g. safe-keeping of fund assets), but less good where more expensive to monitor value for money (e.g. trade execution and foreign exchange transactions).
- Charges for passive investment funds have fallen over the last five years, but charges for actively-managed funds have not and are clustered around specific pricing points. As fund size increases, the management charge does not fall.
- Firms have consistently substantial profit margins of 36 percent on average.
- The *ad valorem* fee model incentivizes growth of assets rather than value for money.
- Most expensive funds do not appear to perform better than other funds, and many active funds offer similar exposure to passive funds but charge significantly more.
- Investors do not receive estimates of transaction costs in advance.
- Concerns about how managers communicate investment objectives and outcomes.
- Investors focus on past performance, which is not a good indicator of future returns.
- Fund governance bodies do not focus on value for money.

“ ... an all-in fee that would indicate all the charges investors will pay ... ”

This stance is at odds with other expert opinion. The **Hong Kong** regulator, for example, has expressed concern that the rise of passively-managed index-tracking funds could harm corporate governance standards in the territory.

Some in the industry have expressed doubts to the FCA about the reliability and accuracy of the data it used. The UK fund body, the Investment Association, says the report does not distinguish between different types of active funds and seems to suggest that active funds should take on more risk to justify higher fees.

Ratings agencies have also expressed doubts over the FCA's findings. In November 2016, Moody's noted that the regulator's proposals could squeeze the profit margins of active fund

managers, saying the FCA's proposed fee structure will require significant expense reduction. Moody's said competition from passively-managed products would require investment managers to "adapt their business models." According to the rating firm, managers that move first "will be most resilient" to changes in the regulatory and market environment.

One of the FCA's proposals is for an all-in fee that would indicate all the charges investors will pay, including transaction costs incurred when a fund manager trades. The interim report found that "some charges, particularly transaction costs, are not disclosed to investors before they make their investment decisions."

Of the four options proposed for the all-in fee, three would require the manager to predict future transaction costs (as will be required by the PRIIP KID). Currently, fund managers are required to disclose in the UCITS KIID an ongoing charges figure based on costs incurred by each fund over the previous year, excluding transaction costs and any performance fee. One option would require the manager to pay for any overspend in predicted transaction costs. Another would require the manager to pay back to the fund any underspend.

According to the FCA, an all-in fee would allow investors to "easily see what is being taken from the fund." A number of fund houses have already introduced measures similar to the FCA's all-in fee

The FCA's proposed remedies to asset management issues

Strengthened duty on investment managers to act in the best interests of investors.

In relation to investment funds:

- independence of fund oversight committees
- an "all-in fee approach" to quoting fund costs and charges
- clarity about fund objectives
- appropriate use of benchmarks
- investor tools for identifying persistent underperformance
- easier switching into cheaper share classes
- clearer communications on fund charges
- increased transparency and standardization of costs and charges information.

In relation to pension funds and other institutional investors:

- potential benefits of greater pooling of pension scheme assets
- increased transparency and standardization of costs and charges
- clearer disclosure of fiduciary management fees and performance
- provision of institutional investment "advice" should come under FCA regulation.

proposals. However, some may set the all-in fee figure at a level that is high enough to "generate certainty" for investors, which could result in higher fees. The FCA acknowledges this risk. Most of the criticism in the study is levelled at the difference between charges for institutional and retail investors and at actively-managed funds. It is said to be difficult for investors to assess the value for money of MMFs, protected funds and targeted absolute return funds. External fund ratings are said to be biased towards actively-managed funds. In addition, while performance fees are not common in UK retail funds, where used, they are often asymmetric.

In the institutional market, pension fund trustees said they sometimes struggle to scrutinize the performance of their investment portfolio as a whole. The FCA notes that information presented by the investment manager is often in a format that is difficult for the client to understand and engage with.

The report acknowledges new requirements under the PRIIP KID Regulation and MiFID II. Some of the FCA's proposed "remedies" are in line with the thrust of these regulations, but others indicate that the FCA is prepared to consider more detailed or, perhaps, different solutions. Coupled with the already stringent UK requirements on inducements, this approach could lead to a greater differential in the regulation of UK investment markets versus the rest of Europe.

Meanwhile, in **Ireland**, the CBI is conducting a thematic review of ongoing charges in UCITS. Its focus is on the quality, comparability and presentation of fee disclosures and, in particular, whether disclosures allow investors to make informed investment decisions. The aim is (a) to build a data-driven approach to the understanding of ongoing charges and (b) to identify funds that are outliers.

The annual submission of UCITS KIIDs forms the basis of this review. In conjunction with other regulatory returns, the KIIDs were analyzed to

provide a comparison of fees at a share class level. The review included both actively- and passively-managed investment funds across the spectrum of equity, bond, money-market and mixed mandates.

Work on fees is due to carry on throughout 2017. The CBI has also announced it will consult further on the disclosure of fees and charges. Information gained from this work will inform its own contribution and input into wider European initiatives on fees.

Remuneration – rules could go either way

In EIMR 2016, we noted that remuneration was high on the regulatory agenda, with IOSCO recommending that the remuneration of the management company be disclosed separately from other costs and charges within investment funds. In **Europe**, the debate was focused on the disclosure of remuneration levels of key individuals within firms – including senior management and portfolio managers – and the firms' remuneration policies.

As the debate progressed in the latter half of 2016, the industry received mixed messages on the remuneration issue. CRD IV, which came into force at the start of 2017, includes a cap on bonuses for material risk takers at 100 percent of fixed salary, or 200 percent where there is shareholder approval. However, in July 2016, the European Commission said it was considering waiving strict banking remuneration rules for some non-banking groups – including investment managers. The Commission wrote to the European Council and European Parliament, saying it would conduct an impact assessment on allowing rule waivers.

The Commission said the application of certain CRD IV remuneration provisions – particularly those on deferral and payout in instruments – "is not efficient if consideration is given to the particular

costs and burdens triggered by the rules on the one hand and the absence of clear beneficial effects on the other”.

However, the European Banking Authority (EBA) launched a data collection exercise asking investment managers to provide specific information on staff falling under the new rules. In December 2016, it announced that the bonus cap should apply to all firms caught under the Directive, including bank-owned subsidiaries and independent firms.

The industry is hoping there will be some flexibility. EFAMA said that imposing CRD IV pay rules on investment managers will impact firms’ ability to attract and retain top talent.

in a larger number of investment management staff in the country falling within the scope of the remuneration rules. The Dutch Minister of Finance said he wanted to extend a bonus cap for material risk-takers to all staff at firms caught by the rules, regardless of their role.

The Dutch proposal, which goes further than the EU provisions, would extend the bonus cap to staff whose functions are not deemed to have an impact on their firm’s risk profile. The Netherlands already has a bonus cap of 20 percent in place for financial services firms. However, UCITS and AIF managers have, until now, been exempt from the rules.

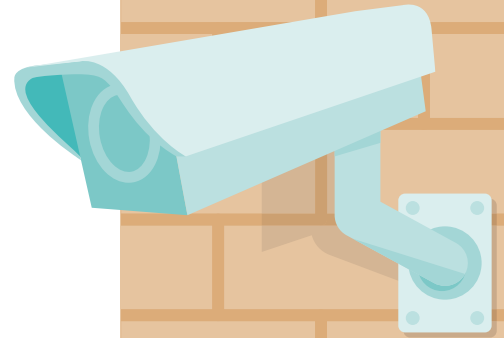


In the **UK**, the Prudential Regulation Authority and the FCA said they would not apply the pay guidelines to UK standalone fund houses.

Similarly, in **Ireland**, the CBI set out in January 2017 “proportionality” principles for the payment of variable remuneration to certain banks and investment firms. Its assessment of quantitative aspects will be guided by threshold levels related to the size of the firm and the level of variable remuneration.

The **Netherlands**, however, is decidedly on the other side of the debate. It has tabled proposals that could result

Investment fund managers must also navigate differences between UCITS and AIFMD requirements. The latter allow for the application of proportionality, but the final ESMA remuneration guidelines (which cover both UCITS and AIFs) are less flexible. The **French** regulator, for one, has clarified that it will align its approach to that under AIFMD.



Products: new rules, new opportunities

Regulators are becoming ever more granular in their scrutiny of different types of fund, with product types and even individual products now in their purview. In particular, some are requiring funds to be clearer about the investors they wish to target.

Also, the alternative funds industry continues to see a trend in the regulation of products that have previously been unregulated.

On the other hand, there are moves to liberalize some products, to enable them to invest in a wider range of assets or to market them to a wider range of investors. Indeed, some jurisdictions are allowing certain types of funds to be unregulated or their managers to be subject to lighter requirements.

Climate change fund regulation is creeping forward slowly. Meanwhile, a number of jurisdictions are seeking to make further improvements to personal pensions and individual savings accounts.





Matching products to investors

MiFID II introduces for the first time at **European** level the concept that detailed product governance should include the identification of a product's "target market".

The requirements apply to firms that manufacture products and to distributors that offer or recommend products to clients. The guidelines will also impact fund managers. Although they are not directly subject to MiFID II, fund distributors will have to seek information from fund managers about their product governance processes and the target market of the fund.

Product manufacturers must put in place product governance processes, from inception and throughout the life of the product, whether it is sold or marketed to retail or professional investors or to eligible counterparties. Firms must ensure that products are manufactured to meet the needs of an identified target market, their distribution strategy is compatible with this target market, and products are actually distributed to the target market.

As fund managers are not directly regulated under MiFID II, it is up to national regulators whether they apply these manufacturer requirements to fund managers, too. The **UK**, for example, already does so.

ESMA's guidelines say the requirements should be applied in a "proportionate" manner, taking into account the nature, scale and complexity of a firm's business and the nature of the product. For simpler and more common products that are compatible with the mass retail market, the target market can be identified in less detail than, say, contracts for difference or structured products, which have more complicated return profiles.

The guidelines also require the identification of a "negative" target market. That is, to whom the product is

not intended to be sold. There may be grey areas between these positive and negative identifications.

How to target a product for a market

ESMA's guidelines require manufacturers to use five categories for defining a product's target market:

- the type of client
- the client's knowledge and experience
- their financial situation, with a focus on ability to bear losses
- their risk tolerance and compatibility of the product's risk-reward profile
- their objectives
- their needs.

Manufacturers do not usually have direct contact with the end-client, ESMA acknowledges. Therefore, the target market identified by the manufacturer may be abstract, whereas distributors should define the target market in a more granular way. However, manufacturers should employ a distribution strategy that favors the sale of the product only to its target market – e.g. discretionary investment management, advised³⁵ or execution-only; delivered face-to-face or online.

National regulators go their own ways on targeting

Some local regulators have already started looking at how firms target investors.

In **France**, the AMF consulted between November 2016 and January 2017 on the use of future performance simulators when firms market products to retail investors. The AMF said it had observed, among both "traditional

³⁵ i.e. a personal recommendation to undertake a specific transaction

How to define target market of a fund?



and non-traditional” firms, an increase in the use of these tools, which can produce overly-optimistic performance indications. The AMF’s objectives are to help guide investment professionals, while also protecting clients’ investments and ensuring they have access to reliable information.

Singapore has introduced a Bill to refine the definitions of accredited and institutional investors. An “opt-in, opt-out” regime will allow investors who qualify for the accredited investor class to choose not to opt-in but to remain as retail investors with greater regulatory safeguards, or to opt-in and willingly forgo such safeguards in order more easily to access a wider range of niche financial products and services, which may be more complex and risky.


As part of the **Australian** government’s response to the Financial System Inquiry (FSI), it accepted in December 2016 the FSI’s recommendations to introduce design and distribution obligations for financial products to ensure that products are targeted at the right people.

In **Canada**, explicit targeting is not on the regulatory table, but the direction of travel is similar. The CSA in December 2016 proposed a new Risk Classification methodology for mutual funds and ETFs. Most funds now have a risk rating and so are, in theory, easier to match to investor profiles. All private and hedge funds are considered high risk. The OSC³⁶ said it will soon start asking to see support for funds’ risk calculations.

In **China**, client suitability is also on regulators’ radar, following a number of incidents where high-risk products were not labeled as such and were sold to clients with low-risk outlooks. Suitability is also rising up the agenda in **Hong Kong**, although no specific provisions are yet in place.

In **South Africa**, the regulator was highly prescriptive in 2015 and 2016 about the products that pension scheme members should use. The first draft of the Retirement Fund default regulations caused a degree of uproar when it was published, recommending that for all default investment portfolios, passive funds should be considered and performance fees should not be

³⁶ Ontario Securities Commission

A woman with long dark hair and a young girl are shopping in a store. The woman is wearing a black top and has a black handbag. The girl is wearing a white long-sleeved shirt and a dark vest. They are both looking at items on a shelf. The background is blurred, showing other shelves and store lighting.

permitted. However, after lobbying efforts from active fund managers, the draft was amended, allowing active funds to be considered and lifting the performance fee ban.

Regulators beef up scrutiny of alternatives

Post the financial crisis, one of the first pieces of new EU legislation was the AIFMD. The **US** SEC is now taking action in this area.

Over the past six years, the SEC has greatly enhanced its knowledge of alternatives through its Presence Exam initiative, hiring experts from the industry, development of new tools and technologies, and a never-ending quest for more data. As a result, examinations of alternative managers have become more challenging and focused.

The increased regulatory scrutiny is challenging chief compliance officers to build stronger compliance programs that can stand up to more focused SEC exams and stave off enforcement actions, which can lead to financial penalties and loss of investor confidence.

In addition, advisors continue to be challenged with adequately disclosing and administering fees and expenses in alternative products. As evidenced by recent enforcement activity, expense and fee arrangements in private funds can be complex and multi-layered (at advisor, fund and operating company levels), which can confuse investors.

The SEC position is that many private equity fund advisors disclose expenses only in broad terms. In other cases, fee and expense disclosures are misleading or not available at all. The SEC has put the alternative industry on notice that the status quo is no longer acceptable.

The SEC is also concerned about the valuation of alternative products. It said the procedures used to value

“ ... procedures used to value investment holdings must address conflicts of interest ... ”



investment holdings must address conflicts of interest: while portfolio managers are generally knowledgeable about the value of a holding, they also typically have a vested interest in the outcome, because it impacts their fees. In addition, those managing multiple funds have a responsibility to ensure that their best investment ideas are allocated fairly among their funds. There should be comprehensive policies, procedures and controls to manage the investment allocation process.

In **Canada**, the Alternative Funds Regime was published in September 2016 for a 90-day comment period. It is effectively a “liquid alts” prospectus-based regime. Prospectus-based funds usually find it easier to get onto scale platforms. The OSC pre-vets the fund, making it an easier sell for a bank or other distributor. The regime contains leverage and borrowing limits, and is being used by providers in tandem with the risk classification scheme in Canada, which has proved an effective marketing tool.

The **UAE** regulators are also becoming more active on alternative products. The Securities and Commodities Authority is holding early conversations about alternative fund regulation

and envisages introducing new requirements. The UAE aims to be a hub for all sections of the funds industry and to become a genuine international finance center. Alternatives are necessarily part of this mix and 2017 sees new requirements on marketing funds in the UAE.

In **South Africa**, management companies were previously regulated, but hedge funds are now regulated too, which has led to the growth of alternative funds. The South African Financial Services Board has recently completed the approval process for applications from new and existing funds. The regulator currently has limited resources and aims to increase its capacity. At present, regulatory scrutiny is on investment strategies and leverage, more than on governance issues.

In the **Netherlands** – a significant domicile for professional investment funds – the regulator (AFM³⁷) proposed that some “harmful” financial products should be banned from the retail market. From mid-2017, the advertising of products such as contracts for difference and binary options will be banned.

³⁷ Autoriteit Financiële Markten

“The current low interest-rate environment and digitalization are creating a fertile base for the arrival of harmful financial products offered online. We are also dealing with parties who offer these products from other countries,” said Merel van Vroonhoven, chair of the AFM.

In **Singapore**, the Securities and Futures (Amendment) Bill 2016 empowers MAS to prescribe certain products, such as buy-back arrangements involving gold, silver and platinum that resemble collateralized borrowing arrangements. It also widens the definition of collective investment schemes that must be authorized or recognized by MAS for public offers to retail investors.

On the other hand, some alternative fund rules are being liberalized

In **Europe**, EuVECA and EuSEFs, which are regulated forms of AIFs, have not proved attractive to either the industry or investors for two main reasons: the narrow investor base and their restriction to smaller fund managers.

A proposal by the European Commission in 2016 addressed the second point and increased the range of eligible investee companies. It additionally prohibited national barriers to the cross-border marketing of these funds. But it does not widen the eligible investor base.

The EuVECA and EuSEF regulations allow smaller fund management companies that are below the AIFMD threshold to market funds cross-border within Europe without opting in to the full provisions of the AIFMD. These funds can be marketed across Europe, using the “EuVECA” and “EuSEF” labels, to professional investors and to

retail investors who invest a minimum of EUR100,000 in any one fund and who confirm they are aware of the risks. A number of respondents to the consultation said this was too high a threshold, but others said that if it were lowered, then additional protections for retail investors would be needed. Given the conflicting views, the Commission decided not to propose amendment of the minimum investment requirement.

The Commission is also considering ways to attract institutional investors and how this might be achieved via a pan-European venture capital fund-of-funds.

And eligible fund investments are being widened

Since the financial crisis and the consequent contraction of bank credit, funds have increasingly filled the space that banks used to occupy. A raft of new fund types, under the broad umbrella of “alternative credit” have been created, and regulators are starting to take a closer look at these funds. Some also realize they need to do more to facilitate the creation of funds that may help foster economic growth.

In **Ireland**, the CBI has relaxed rules governing the issuance of loans by alternative investment funds. The rule change, announced in December 2016, allows “qualified investor alternative investment funds” to invest for the first time in debt and equity securities of companies to which they lend. The funds can hold these securities for hedging, treasury or cash management purposes.

Ireland was the first country in Europe to set up a regulatory framework for loan origination funds in 2014. It was closely followed by **Germany**, where BaFin has revamped its approach to products regulated under AIFMD,

“ ... funds have increasingly filled the space that banks used to occupy. ”

“ ... follow any strategy and invest in any type of assets. ”

allowing some closed-ended funds to lend directly to companies.

Most recently, in **France**, the government issued a decree in November 2016 that gave professional funds and professional private equity funds permission to grant loans.

In **Brazil**, regulatory order ICVM 578 gives fund managers flexibility to invest in Brazilian limited companies and permission to make payments in advance for future capital increases in the investee companies. It introduces new categories of the Fondo Investimenti Piemonte (FIP) scheme, such as the Multi-Strategy FIP, which may allocate 100 percent of its subscribed capital to non-Brazilian assets. Funds may now invest up to 33 percent in non-convertible debentures.

In **India**, SEBI was due to give mutual funds permission to trade in commodity market. At the time of writing, detailed guidelines were awaited. In addition, SEBI has raised mutual funds' exposure limit to housing finance companies from 10 percent to 15 percent.

SEB has also amended the rules for Real Estate Investment Trusts and introduced Infrastructure Investment Trusts. Both are generating considerable interest.

More jurisdictions allow unregulated funds

Cyprus plans to introduce a regime for “registered”; but not authorized, AIFs to facilitate quick and cost-efficient fund launches. Similar to the Luxembourg Reserved AIF – which has proved popular – the Cyprus Registered AIF will be able to market to professional and well-informed investors, and will be managed by a full scope EU alternative investment fund manager (AIFM).

The Registered AIF may be organized in any legal form available under Cyprus Law (investment company with fixed or variable capital, limited partnership or common fund), it can be open or closed-ended, and it can follow any strategy and invest in any type of assets. But it cannot be an MMF or a loan origination fund.

In addition, the new “Mini Managers” (licensed sub-threshold AIFMs), other investment firms and UCITS management companies in Cyprus may manage registered AIFs, provided the funds are closed-ended limited partnerships and invest more than 70 percent in illiquid assets.

Cyprus has also introduced a list of non-management safe harbors for limited partners, to give greater legal certainty to investors.

The new rules were due to be passed into law in mid-2017.

Guernsey has introduced two new fund products. Most recently, in December 2016, the Private Investment Fund (PIF) was introduced for sophisticated investors. The PIF is an entirely new category of fund for Guernsey and offers a number of advantages over traditional, more regulated funds. Significantly, the application for a PIF will be processed by the Guernsey regulator within one business day and fund documents are not subject to disclosure requirements, which reduces the cost and processing time for launches.

The other new fund is the Manager Led Product (MLP) which has been adopted in anticipation of Guernsey being granted a third-country passport under the AIFMD. The regulatory focus of the MLP regime is on the AIFM rather than the fund, thus mirroring the AIFMD.



Climate change fund regulation creeps forward

In EIMR 2016 we reported that, post the December 2015 treaty on climate change, signatory countries were turning their attention to how they can encourage or require investors and investment managers to adopt strategies that will support countries in meeting their new commitments.

France led the way. Management companies must report by 30 June 2017, on their website and in their funds' annual reports, how social, environmental and governance aspects are taken into account. A comply-or-explain approach has been adopted at this stage with the aim of developing best practice. Also, two certification tools have been created for financial products that integrate environmental, social and governance criteria.

Otherwise, regulatory progress has been slow.

In **Malaysia**, the Securities Commission in January 2017 unveiled a Five-Year Blueprint to strengthen Malaysia as an international center for Islamic fund and wealth management. Initial work programs will include the formulation of a framework for SRI³⁸ funds.

Sweden proposes to require AIFs to provide information on their investments and the consequences for sustainability. Also, if the fund does not have sustainability as a focus, this must be declared.

The **Luxembourg** Finance Labelling Agency has launched a new label for funds that invest at least 75 percent in companies that seek to mitigate and/or adapt to climate change. The independent certification can be granted to UCITS or AIFs, domiciled in the EU or elsewhere.

³⁸ socially-responsible investment

“ ... realization that local assets alone cannot adequately diversify portfolios. ”

Discussions are now taking place at **European** level. ESMA is considering the provision in the PRIIP KID (see Chapter 3) relating to an investment product’s environmental objective, and MEPs³⁹ across the political spectrum are seeking the industry’s views on what needs to be done at legislative level.

Initial thoughts include the need for clarity on what is and what is not SRI, convergence of accounting and reporting requirements, and standardization of the identification and calculation of investment risk. Concerns have also been expressed that regulatory and tax initiatives need to be better aligned, both with each other and with long-term investment horizons.

Meanwhile, the OECD⁴⁰ has issued a report on institutional investors’ approach to SRI issues. It highlights the difficulties institutions face in reconciling their obligations to their beneficiaries with SRI investing and the lack of regulatory clarity.

Investment managers have a key role to play in encouraging investing institutions in the right direction via their communications and the investment strategies they offer. This may require firms to adjust their investment and operational processes.

KPMG, in partnership with the United Nations Global Compact, publishes a Sustainable Development Goals Industry Matrix, which provides information on Sustainable Stock Exchanges.

Low returns and low savings rates drive search for better pension and savings products

In **Australia**, which already has a vibrant pensions industry, a consultation was launched in December 2016 on

the development of the framework for Comprehensive Income Products for Retirement. The “MyRetirement” framework is intended to increase individuals’ standard of living in retirement, increase the range of retirement income products available and empower trustees to provide members with an easier transition into retirement.

The latest consultation focuses on the structure, minimum requirements, regulatory framework and offering of these products.

In **Canada**, there has been much debate about pension reform at provincial and federal government levels, driven largely by increasing longevity and declining individual savings rates. Some provincial governments have proposed mandatory provincial pension plans, providing an extra layer to the federally-run Canada Pension Plan (CPP), in order to provide benefits for a wider spectrum of retirees. However, in October 2016 the government agreed to expand CPP. Contributions by employees and employers will increase over seven years starting in 2019, as a way to boost benefits for future generations of retirees. The proposal was held up amid criticism from business owners, who complained they would have to boost contributions for their workers. As a result of the expansion of CPP, most provincial plans are expected to be jettisoned.

In **Mexico**, the regulator is pushing all pension plans to implement Global Investment Performance Standards (GIPS) in return for being allowed to invest in overseas securities. In practice, it is the investment manager, rather than the pension plan, which must be GIPS-compliant. The desire to invest in overseas assets stems from growth in the Mexican pension fund industry and a realization that local assets alone cannot adequately diversify portfolios. The regulator has also expanded the potential use of derivatives by pension funds, in line with IFRS⁴¹.

³⁹ Member of the European Parliament

⁴⁰ Organisation for Economic Co-operation and Development

⁴¹ International Financial Reporting Standards

In addition to improvements to the Nippon Individual Savings Account, the defined contribution pension law has been revised in **Japan** to respond to new working styles and make defined-contribution investing more portable. This has led to a huge expansion of the subscriber base to the “iDeCo” (individual type defined contribution pension plan) product. The revision abolished most restrictions that were in place and allows civil servants, subscribers to corporate pensions and homemakers to join the scheme. Some 67 million people are now eligible to open an account – 27 million of them starting from 2017.

As a result, more investment management and securities companies have entered the market. Investors cannot yet put stocks or ETFs into an iDeCo account but can purchase most mutual funds. The costs are slightly higher than the cheapest ETFs, but the tax savings on the account tend to make up for that.

Proposals for the Piano individuale di risparmio, or Pir, which is similar to an individual savings plan, were approved at the end of 2016 by **Italy**'s government and came into force in January 2017. Investors using the Pir can avoid capital gains tax on investments of up to EUR30,000 a year, as long as at least 70 percent of the portfolio is invested in Italian companies, via shares or investment funds. At least 30 percent of that portion must be invested in small and medium-sized enterprises in the country, while users are permitted to hold their investment in the vehicle for no longer than five years.

Swedish fund managers will be able to operate investment savings accounts by January 2018. Meanwhile, the debate in **Europe** on the creation of a pan-EU personal pension product continues. It has gained political momentum as it is now seen as a key plank of the CMU initiative, but draft rules are yet to be issued.

Accounting standards may frustrate fund investment by institutions

IFRS 9, which comes into effect in January 2018, will no longer allow institutional investors in investment funds to use fair accounting treatment rules. Fair accounting is preferred by long-term investors, such as pension funds, since it reflects their long-term investment horizons and means their accounts are not skewed by short-term fluctuations in the valuation of their assets. Under IFRS 9, investors will have to report their fund investments at profit and loss, which means any volatility in the fund is reflected in investors' net results.

The fund management industry has admitted it was slow to recognize the significance of the incoming standard, which was endorsed by the European Commission in November 2016. In February 2017, EFAMA said the industry “discovered the issue quite late”.

The inability to use the fair value accounting treatment applies only to investments in funds, whereas investors who hold securities directly can continue to use fair value. This, says EFAMA, may lead clients to ask investment managers to move them out of funds and into separate accounts. Alternatively, some investors may even abandon third-party investment managers and start investing on their own accounts.

Open-ended investment companies encouraged

A number of jurisdictions around the world have decided to launch open-ended investment companies, aiming to replicate the success of the SICAV⁴² in continental Europe or the OEIC⁴³ in the UK.

MAS has been consulting on a new corporate structure for investment funds, called the **Singapore** Variable Capital Company. It is intended to be a more efficient fund structure and the hope is that more fund managers will establish there.

Not to be outdone by its Asian rival, **Hong Kong** has launched an OEIC initiative too. A consultation is expected in 2017.

Meanwhile, **Mexico** is also considering a SICAV-type structure, although the Mexican version operates more like a private equity fund and is designed to hold long-term investments. It is primarily aimed at regulated pension funds.

⁴² Société d'investissement à Capital Variable

⁴³ Open-Ended Investment Company

Cross-border business meets major crossroads

The impacts of regulation on the cross-border distribution of funds or investment management services – whether enabling or restricting – have been carefully watched by the industry for many years.

The cross-border fund passport, which was kicked off in **Europe** by UCITS nearly 30 years ago, has spread to other funds and other parts of the globe. The passporting trend has seemingly been unstoppable — a natural adjunct to the increasing globalization of financial services. However, obstacles to this trend have appeared, within both **Asia** and Europe.

And a much more significant obstacle looms on the close horizon, for both funds and investment management — “Brexit”. The **UK**’s decision to leave the EU is a national decision, but Brexit will be an international event with significant regulatory ramifications, around Europe and globally.

Meanwhile, some regulators remain intent on opening up their capital markets, which should be good news for investment managers.





Asia: Are bilateral agreements more promising than regional passports?

In EIMR 2016, we commented extensively on the three **Asian** passports under development. The three – the China Mainland-Hong Kong Mutual Recognition of Funds (MRF), the Asian Region Funds Passport (ARFP) and the Association of South-East Asian Nations Collective Investment Scheme Framework (ASEAN) – have had varying fortunes.

We noted that under the MRF there had been more “southbound” activity than “northbound”. This reflected restrictions on the size of northbound flows to prevent **Hong Kong** investment firms setting up funds purely to be distributed in **China** to take advantage of the huge untapped market. Chinese funds, which tend to be larger, were seeing fewer opportunities to distribute into the Hong Kong market.

Little has changed since then and activity, if anything, has slowed down. Only a handful of Hong Kong funds have been approved for distribution in mainland China and there have been no new approvals for months.

Progress on the agreement to formalize the ARFP, which combines the initial signatories **Australia, New Zealand, Singapore** and **South Korea**, with the **Philippines** and **Thailand**, has also been slow. While a Statement of Understanding was signed in September 2015, negotiations have been bogged down since. Singapore left the group, saying it would consider returning only when a number of tax considerations are clarified.

Some progress was finally achieved in April 2016, when representatives from **Australia, Japan, New Zealand** and **South Korea** signed the ARFP Memorandum of Cooperation (MoC). **Thailand** was a subsequent signatory.

The MoC came into effect on 30 June 2016, with participating jurisdictions having 18 months to implement domestic arrangements to comply with the ARFP regime.

Regarding ASEAN, there has been little or no new activity since last year, but Singapore continues to be a strong supporter of this passport initiative.

Despite the somewhat disappointing take-up of the regional passporting schemes, there has been progress in bilateral agreements. In December 2016, for instance, the People’s Bank of **China** granted **Ireland** a RMB50 billion quota under the RQFII Scheme⁴⁴, which will allow Irish-domiciled funds to purchase securities in local Chinese Markets. Further enhancing Irish funds’ ability to access Chinese mainland markets, the Chinese Central Bank also said it would begin accepting applications for investment through Shenzhen Connect, to which Irish funds were granted access in 2015.

Similarly, under a memorandum of understanding between **Hong Kong’s** SFC and the **Swiss** Financial Market Supervisory Authority, eligible Swiss funds can now be sold in Hong Kong, and eligible Hong Kong funds will enjoy the same treatment in Switzerland.

Non-European alternative funds still await the passport

The AIFMD provides that, three months after receiving a positive opinion from ESMA, the Commission may introduce a third-country passport that allows AIFs in non-EU countries to be sold cross-border to EU professional investors and non-EU managers to manage EU AIFs. However, the Commission has still not granted the passport to any non-EU countries, despite ESMA’s advice in July 2016 that the passport should be given to 12 non-EU countries.

⁴⁴ Renminbi Qualified Foreign Institutional Investor

AIFMD non-EU passports – ESMA’s advice of July 2016

- No significant obstacles impeding the application of the AIFMD passport to **Canada, Guernsey, Japan, Jersey** and **Switzerland**.
- No significant obstacles for **Hong Kong** and **Singapore**. However, both jurisdictions operate regimes that facilitate the access of UCITS from certain EU Member States only.
- No significant obstacles for **Australia**, provided the Australian Securities and Investments Commission (ASIC) extends to all EU Member States “class order relief”.
- No significant obstacles for the **US**. However, for funds marketed by managers to professional investors that do involve a public offering, a potential extension of the AIFMD passport to the US risks an uneven playing field between EU and non-EU AIFMs. The conditions that would apply to these US funds would potentially be less onerous. ESMA recommends that the EU institutions consider options to mitigate this risk.
- For **Bermuda** and the **Cayman Islands**, ESMA could not give definitive advice. Both countries are in the process of implementing new regulatory regimes.
- For the **Isle of Man**, ESMA finds that the absence of an AIFMD-like regime makes it difficult to assess investor protection.

The Commission has indicated that there are a number of issues to resolve, including taxation and anti-money laundering (AML). It now seems likely that third countries might have to wait until deep into 2018 for progress. A European Council group is preparing a consolidated list of “non-co-operative” jurisdictions from a tax perspective. Countries are being assessed on their approach to issues such as their commitment to tax transparency, “fair” taxation, and implementation of anti-tax avoidance measures under the OECD’s Base Erosion and Profit Shifting program.

The Commission may decide to delay extending the AIFMD non-EU passport until this work is nearer completion. Industry commentators have questioned whether the delay is also partly due to Brexit, given the large number of **UK** AIFs and UK AIFMs that currently operate under the AIFMD’s EU passport.

Some jurisdictions are not overly concerned by the lack of introduction of the non-EU passport. The **Isle of Man**, for example, has decided not to aim for AIFMD equivalence. Also, for some asset classes, the national private placement regimes continue to be workable for the time being.

Brexit – UK decision, global issue

The industry now faces potentially the single biggest impact on cross-border financial services in a generation – Brexit. Considered an unlikely event in early 2016, here we are in 2017 with Article 50 triggered and a 2-year timetable in place for the **UK**’s exit from the EU.

Brexit is not just about the future of London as a financial center or of the UK-based investment and fund management industry. Firms within other EU Member States (“EU27”) and elsewhere will be impacted.

Much business takes place from and to the UK via EU regulatory passports. For funds and management companies (ManCos) the key passports are in the UCITS Directive and the AIFMD. For the provision of investment management services, the MiFID II passport is king. The passports work differently in all three directives and their loss would have different impacts in the retail and professional marketplaces.

Equivalence – a poor substitute

There is a diversity of “third-country” provisions under different pieces of EU legislation and some have no formal “equivalence” regime. The provisions in MiFID II, AIFMD and the UCITS Directive are all quite different, for example.

Equivalence regimes cover only a subset of the activities that currently benefit from passports for EU firms. Therefore, unless the final trade agreement between the EU and the UK includes arrangements for UK firms to continue to benefit from all EU passports (which, politically, seems unlikely), Brexit will result in EU27-UK cross-border business being prohibited or restricted.

Moreover, gaining equivalence status is neither a singular nor a one-off process for a third country – it requires a different judgment for each piece of legislation and those judgments are subject to review at any time.

ESMA has said that the EU framework for third countries is not fit for purpose and requires overhaul. In fact, there is no generic framework, with different arrangements in different pieces of legislation – which are a mixture of equivalence, endorsement, recognition or passporting – or no arrangement at all. Also, it is time- and resource-intensive, requiring detailed assessments of third countries’ regimes and lengthy negotiations if a country is not initially judged equivalent.

Implications of the loss of the three key EU passports

UCITS

UCITS are, by definition, EU-domiciled funds with EU-domiciled ManCos.

Therefore, absent a specially negotiated deal and changes to UCITS legislation, UK UCITS will no longer be UCITS and UK ManCos will no longer be able to be ManCos for EU27 UCITS.

EU27 UCITS invested in UK UCITS may have to divest, unless UK UCITS are accepted as “equivalent”.

There is no obvious regulatory reason why EU27 UCITS should be prevented from marketing to UK retail investors. However, if UK UCITS can no longer be sold into the EU, there is a political risk that EU27 UCITS will no longer be able to access UK retail investors.

AIFs

Unlike the UCITS Directive, both AIFs and AIFMs may be EU or non-EU. Therefore, in theory, there is nothing at EU level to prevent EU27 AIFs continuing to be sold into the UK (and

vice versa), or for EU27 AIFMs to manage UK AIFs (and vice versa).

However, the AIFMD non-EU passports have not been introduced and a number of the EU27 do not have, or have very restrictive, private placement regimes. If UK AIFs cannot be sold into these countries, there is a political risk that AIFs domiciled in those countries will not be able to be marketed into the UK.

Some Member States allow UK authorized retail AIFs to be sold to retail investors in their country, and vice versa. Again, there is a political risk of these arrangements being disrupted.

Investment management of funds

Both the UCITS Directive and AIFMD allow the investment management function to be delegated, provided there is still “substance” in the home Member State.

ESMA is promoting a common understanding of the substance

requirements for UCITS ManCos and AIFMs. It has also called for the disparate third-country regimes in EU legislation to move to a common approach. Brexit adds political momentum to both these debates.

Investment management of separately managed accounts

Under MiFID II, UK firms should be able to continue to provide investment management services to EU professional clients. However, the client may itself be subject to national rules that restrict its choice of investment manager (e.g. some pension funds). This is mainly an issue for UK-based investment managers, but, again, there is a political risk of similar issues for EU27 firms that provide investment management services to UK professional clients.

In the wealth management arena, EU27 firms may not be able to market their services to UK clients, and vice versa.

Mr. Maijoor cited the equivalence system under EMIR: “The EU is an island of third-country reliance in a world that has mostly opted for individual registration of CCPs that want to do cross-border business.” ESMA has limited opportunities to see the specific risks that third-country CCPs might be creating in the EU as it has limited powers regarding information collection and risk assessment, and no regular supervision and enforcement tools.

It remains to be seen how quickly and in what ways the co-legislators will respond to this call for an overhaul of the system. Certainly, it would be a major drafting and practical task to bring about greater consistency of approach. Political pressures, in Europe and beyond, may provide momentum behind the task. In the meantime, firms

and market entities will wish to factor into their business planning that the third-country provisions of today may look rather different in a few years.

UK trade agreements with non-EEA countries

The day of Brexit will not be the end of the story. The UK will need to negotiate new trade agreements with non-EEA countries where it currently benefits from EU agreements. The time gap in securing these agreements will impact firms in the UK, across Europe and more widely.

For example, business is currently done between the UK and **Switzerland** under Switzerland’s trade agreement

with the EU. Post-Brexit, this business will be uncertain until the UK agrees a new trade deal with Switzerland. Not only will UK and Swiss firms be affected: other firms (within the EEA or elsewhere) with operations in both the UK and Switzerland, and which depend on that border remaining open, will be impacted too.

Many other Brexit issues to navigate

In addition to the three main regulatory passports, EU investment and fund managers benefit from a number of other passports, protections and activities that will be impacted by Brexit. Here are just a few:

Post-Brexit, UK financial instruments and UK regulated markets will no longer

“ ... the UK’s decision to leave the EU results in increased risks to consistent supervision. ”

be EU/EEA instruments and markets. A number of professional clients are required to be predominantly invested in EU/EEA financial instruments or to trade via EU/EEA regulated markets. Investment managers will have to adjust these clients’ portfolios.

As the investment banks adjust their operations, so the capital markets, market liquidity and trading venues will change and evolve. The front offices of investment managers will have to adapt to these changes and they may have to change their internal dealing support systems.

Even if firms do not relocate any of their operations (from or to the UK), they will have to navigate contract law, employment law and tax law issues: for example, what will happen to VAT arrangements for EU27 members with operations in the UK? What impact might there be on the process for tax treaty claims?

Some EU27 members route data via the UK and then on to other destinations (e.g. the US). How will this work post-Brexit under the new EU General Data Protection Regulation (GDPR), which includes specific extra-territoriality provisions?

EU Member States vie for UK firms and talent

Since the Brexit vote, there has been no shortage of pronouncements from EU Member States hoping to increase their share of investment management and fund activities, including **France, Germany, Ireland, Italy** and **Malta**. And other countries’ regulators are positioned to deal with more applicants.

In October 2016, **France’s** AMF unveiled a new program designed to help foreign investment managers and other financial firms navigate the authorization process. Existing documents already approved by the UK

regulator are sufficient – French-specific documents need not be drawn up – and an English-speaking contact point will be in place to assist applicant firms. The “one-stop shop offer” provides a pre-authorization procedure, allowing firms to begin opening offices in France in just 2 weeks.

Also, in March 2017, the AMF announced, that under the “FROG” initiative, it is reviewing its approach in a number of areas, including allowing French fund managers to delegate to appropriately authorized investment managers and not only to other fund managers.

Germany is considering changing its labor laws to make Frankfurt a more attractive hub for investment managers and other financial services firms looking to move staff out of London. One German website, which went live immediately after the UK vote, reads “Welcome to FrankfurtRheinMain” and offers a 24-hour UK-based hotline for companies thinking of opening an office in the area.

Ireland’s central bank has seen a “material increase” in the number of authorization queries from UK firms looking to establish a presence in Dublin following the Brexit vote. The regulator has stated its commitment to transparency, consistency and predictability in its approach to authorizations, and has made public considerable information on Brexit-related authorizations.

The **Luxembourg** regulator has confirmed being faced with an increased demand from UK-based investment and fund managers, and that it will only authorize new firms in line with existing EU requirements, notably regarding substance.

In December 2016, **Spain** launched a campaign designed to attract UK-based investment managers and other financial services firms. The CNMV created a “dedicated welcome program” designed to “contribute to making Spain the most appealing option

for investment firms considering a move from the UK to another EU country." It plans to create a single contact point for applicants, provide and accept documentation in English, and establish a two-month fast-track authorization process for UK firms following a two-week pre-authorization period.

Increased competition to London may also lie outside the EU. The government of **Switzerland** said in a federal council report, "Financial Market Policy for a Competitive Swiss Financial Centre," that Switzerland's investment and wealth management industry should be able to capitalize on Brexit. "While asset management and investment banking are well-established strengths of London's financial center and are likely to remain so, Switzerland can build on its strong position in the area of cross-border asset management."

ESMA takes aim at delegation practices

Would-be rivals to London within the EU have been warned that unfair practices to attract business will not be welcomed. ESMA said, in March 2017, that it was investigating risks of "regulatory arbitrage," whereby national regulators try to attract jobs and tax revenue by offering lighter regulatory supervision.

Mr. Maijor observed that the UK's decision to leave the EU results in increased risks to consistent supervision. He urged national regulators not to compete on regulatory and supervisory treatment, citing the ability for EU firms to delegate or outsource to a UK entity while being registered and supervised by one of the EU27 regulators. In May 2017, ESMA issued nine principles on how to deal with firms that are relocating, with the aim of ensuring a consistent approach to authorisation and supervision, including that the firms must have "substance"

When coupled with the upcoming review of AIFMD and consideration of the future shape of the EU's third-country regimes, fund managers around Europe may have to reconfigure their business models. The common practice of domiciling a fund in one Member State and delegating the investment management function back to the UK is likely to come under increasing scrutiny and regulatory restriction.

EU determined Brexit won't derail CMU

The EU is determined not to let Brexit cause its plans for CMU to meander or fail. A statement by the Commission in September 2016 gave a clear signal that developing stronger capital markets in the EU is still a priority. It called for an acceleration of the reforms, starting with the long overdue securitization package and implementing the Prospectus Regulation.

It unexpectedly launched a Mid-term Review and consultation process on 20 January 2017. The intention was to complete the review in June 2017 with a view to identifying additional measures required to improve the financing of the European economy.

CMU is primarily designed to help channel private savings into the European economy, to the benefit of the economy, capital markets and investors. Its mechanism involves substantial improvements to cross-border distribution, creating large pools of assets from across the Member States.

One of the CMU Action Plan work-streams is to review and address national barriers to the cross-border distribution of investment funds. If funds can do business more easily across borders, they can achieve larger economies of scale and compete to deliver better value and innovation for consumers.

“... the cross-border fund market is successful but remains geographically limited.”

According to Commission statistics, about 80 percent of UCITS and 40 percent of AIFs are marketed across borders, but one-third of these are marketed into only one Member State, usually the state in which the investment manager is domiciled. Another third are marketed into no more than four other Member States.

The Commission's research findings, announced in March 2017, were that the cross-border fund market is successful but remains geographically limited. "The reasons for this may include the concentrated fund distribution channels in individual Member States, cultural preferences and a lack of incentives to compete across

borders," the Commission said. Other reasons include the additional national requirements imposed by Member States when transposing AIFMD and the UCITS Directive.

The Commission has identified six categories of national barriers. Their proposed removal will test Member States' commitment to CMU and to the principles of harmonization enshrined in the UCITS Directive and AIFMD.

1. **Marketing:** Host Member States can set national requirements on financial promotion and consumer protection. This gives rise to initial research costs for firms and to additional ongoing costs.

CMU Mid-Term review: key focus areas

SMEs⁴⁵: Broaden sources of finance, extend geographical reach of financing, and give more access to technology and business know-how. The aim is to enable SMEs to grow faster and, potentially, become European "unicorns".

IPOs⁴⁶: EU public equity and debt markets lag behind other developed economies. To support SME listings, MiFID II will create a new Multilateral Trading Facility category of SME Growth Markets.

Crowdfunding: Divergences in regulation and in interpretation of EU rules may lead to market fragmentation, challenging investor protection.

Venture Capital: Stimulate private funding, and encourage venture debt, private placement and pre-IPO funding.

Corporate bond markets: Review how market liquidity can be improved and the potential impact of regulatory reforms.

Infrastructure: Fund investment shortfalls by mobilizing institutional capital. Regulation may reduce

financial institutions' ability to finance long-term investments, in particular infrastructure.

ELTIFs: Facilitate development of the market.

Sustainable investment: Common definitions and standards are lacking.

Fostering retail investment: Consumers lack confidence in capital markets. More transparency around costs and fees is required.

FinTech: Balance between enabling the development of FinTech and ensuring confidence for investors.

Tax: Barriers, notably withholding tax, continue to hinder cross-border investment.

Corporate governance: Divergences in approach may deter investors from investing across borders.

Supervision: Divergences in outcomes lead to cross-border spillovers and unjustified differences in the supervision of the same risk.

⁴⁵ small to medium enterprise

⁴⁶ initial public offering



“ ... retail investors should receive the same level of protection independent of the location of the firm providing the service. ”

2. Distribution costs and regulatory fees: EU funds can be subject to regulatory fees imposed by home and host Member States that vary significantly in scale and calculation methods.
3. Administration: a number of Member States impose special administrative arrangements to make it easier for investors to subscribe, redeem and receive payments from funds. As part of its background work in producing the final ELTIF RTS, ESMA researched arrangements and found that some Member States force funds to use certain institutions and provide additional information to both the regulator and investors.
4. Distribution networks: despite the increasing use of online platforms to distribute funds nationally, barriers exist across borders.
5. Notification processes: when fund documentation has to be updated, managers are required to give written notice to the host regulator, adding cost and time to the process.
6. Taxation: different tax treatments create barriers to cross-border business. The Commission seeks feedback on how to promote best practice and avoid discriminatory tax treatment.

Meanwhile, ESMA has made it clear that retail investors should receive the same level of protection independent of the location of the firm providing the service. This is seen as important both to the free movement of services within the EU in general and to the success of the CMU initiative in particular.

Other markets opening up

Investors are starting to gain more access to **Indian** markets. The regulator now allows designated foreign portfolio investors to invest in unlisted corporate debt securities and securitized debt instruments in India.

The Dubai Financial Market, one of the **UAE's** stock exchanges, has launched a platform for transacting in ETFs, which is subject to regulations developed in collaboration with traders. “Dubai Financial Market is committed to its strategy of providing investors with a wide range of innovative products,” said Essa Kazim, chairman of the exchange.

Technological innovation challenges industry and regulators

Innovation and automation are starting to disrupt and reshape the investment management industry, threatening traditional fund firms, according to The World FinTech Report.⁴⁷

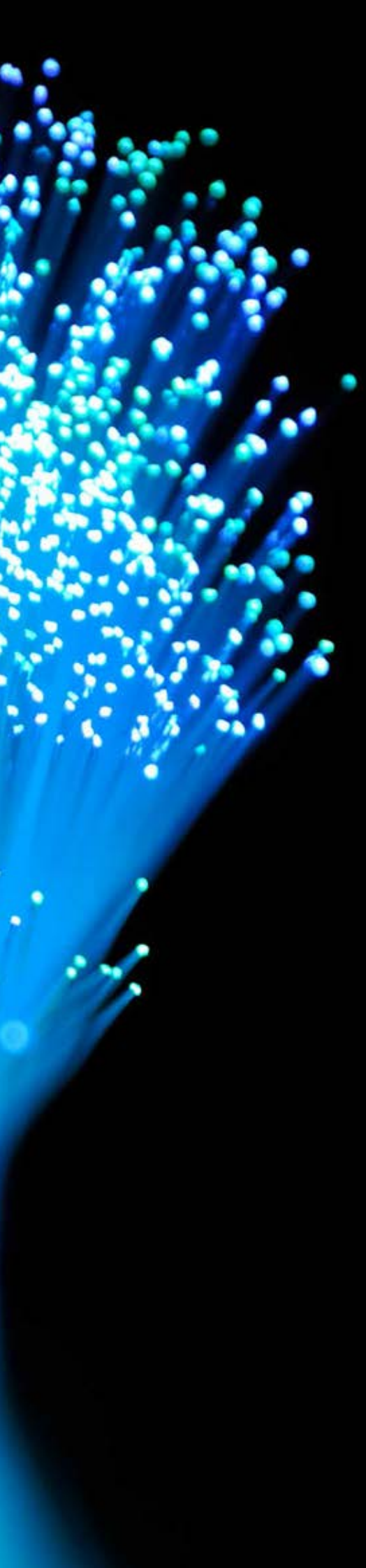
In the area of robo-advice, the report says some 17 percent of respondents worldwide exclusively use FinTech companies to invest their savings. Another 27 percent of respondents use a FinTech service alongside a traditional funds firm.

New technologies are also impacting firms' back offices, such as the rise of distributed ledger technology (DLT). Technology can have positive impacts: it can bring efficiencies in transactions in fund units, for example, and help firms and regulators meet the increasing demands for data, including fiscal authorities' demands for information on fund investors.

However, innovation is causing regulators to question whether existing rules and supervisory approaches are fit for purpose. Prior concerns about cyber-security, money laundering and terrorist financing are amplified by recent attacks.

⁴⁷ <https://www.capgemini.com/the-world-fintech-report-2017>





Regulators cheerlead the FinTech revolution

Many investors want a better and more convenient way to engage with fund managers. It is inevitable that customers would expect a level of service on a par with Amazon, the gold standard for retail technology. This expectation provides a significant challenge for financial firms burdened by legacy systems.

Regulators are recognizing the challenges. In its CMU report of mid-2016, the **European** Commission said it would “continue to promote the development of the FinTech sector and ensure that the regulatory environment strikes an appropriate balance between promoting FinTech and ensuring confidence for companies and investors.” The Commission has also made provisions for the use of FinTech in existing legislation, including MiFID II, the Payment Services Directive and EMIR.

In March 2017, it issued a consultation paper on the development of its policy approach towards technological innovation in financial services. It is seeking “a genuine technology-enabled single market for retail financial services”.

National regulators are recognizing the opportunities and are, in the main, happy to facilitate the roll-out of FinTech in their jurisdictions.

In **France**, the AMF launched a joint FinTech forum in July 2016 and set up a new FinTech, Innovation and Competitiveness division. Its objectives are: to accompany the development of new companies during their pre-authorization phase; to identify new models, techniques and financial technologies with the ability to disrupt current client behaviors and market practices, and to assess related risks; and to increase Paris’s competitiveness as a financial center.

In **Japan**, the JFSA has committed to creating a favorable ecosystem

for the growth of FinTech start-ups, to support the legal framework for FinTech and to help investment managers that implement new technology. It is establishing a panel of experts to discuss possible measures and has exchanged letters with the **UK’s** FCA on a co-operative framework to assist companies seeking to enter the other market, with the intention of reducing regulatory uncertainty and time to market. The UK has also signed co-operation agreements with Hong Kong, allowing information sharing.

In **Singapore**, MAS has taken strides towards building a Smart Financial Centre. In collaboration with a number of Singaporean government agencies, it has set up a FinTech office to serve as a single point of contact for all FinTech-related issues and to promote Singapore as a FinTech hub.

In November 2016, MAS published its “regulatory sandbox” guidelines to encourage and enable experimentation of solutions that utilize technology innovatively to deliver financial products or services. It allows innovative solutions to be experimented with, even if the solution or the developer of the solution does not fully meet MAS’s regulatory requirements.

Also in November 2016, the **Luxembourg** government and its private sector partners, including financial services firms and auditors, founded the Luxembourg House of Financial Technology to support FinTech start-ups. They are supporting the project together with the City of Luxembourg, the University of Luxembourg and the local chamber of commerce.

In **Switzerland**, the government said in a federal council report, entitled “Financial Market Policy for a Competitive Swiss Financial Centre”, that it would foster innovation in financial services by removing “disproportionate barriers to market entry” for FinTech firms. At present, the focus is on amendments to banking law.

Investment managers have no time to lose on innovation

Next 3 years will be critical

74%

Almost three-quarters of investment management CEOs said that the next 3 years will be more critical than the previous 50 for their organization amid disruptive technologies emerging.

In **Thailand**, one of the regulator's four strategy themes for 2017–19 is to embrace FinTech as a tool for adding value and creating more efficient market and accessibility for all stakeholders. Additionally, the regulator will use RegTech for better regulatory supervision and place high importance on cyber resilience.

FinTech is not getting a completely free ride

FinTech is new and its influence is set to grow, so it is only natural that some caution is being expressed by regulators.

Brussels has employed a new internal taskforce to investigate **Europe's** FinTech industry amid concerns customers and consumers are not adequately protected. The taskforce, which was launched by the European Commission in November 2016, brings together Commission expertise on financial and digital services,

and cyber security and consumer protection. It is examining all areas of FinTech, including DLT, robo-advice and regulatory technology, such as compliance monitoring software.

Mark Carney entered the fray in his capacity as FSB Chair to ask if FinTech might lead to risks to financial stability and what macro-regulatory responses might be required. In a speech in January 2017, he warned that some innovations could generate systemic risks through increased interconnectedness and complexity, greater herding and liquidity risks, more intense operational risk and opportunities for regulatory arbitrage. This may require a more intense focus on the regulatory perimeter, revised prudential requirements, more broad-ranging resolution regimes, and a more disciplined management of operational and cyber risks. The FSB is currently investigating the risks of FinTech and will present its findings at the G20 meeting in July.

Robo-advice: widely seen as a force for good

Automated advice is entering the mainstream in both developed and developing markets. On many robo-advice platforms, customers can visit a website to answer questions about their personal and financial circumstances, then software suggests a relevant investment strategy. Fees are considerably lower than for traditional financial advisors, and robo-advice is seen as a middle way between self-service investment and face-to-face investment advice.

Robo-advice has grown to be a key component of the FinTech revolution, impacting asset allocation, portfolio selection and trade execution, and many regulators see it as a force for good.

In **Hong Kong**, internet distribution platforms and robo-advice have been welcomed by the regulator as a way to break the stranglehold of banks over fund distribution. The regulator has been looking at ways of encouraging other channels of fund distribution for a number of years, including via the stock exchange.

In **Australia**, ASIC released its guidance on regulating digital advice in August 2016. The regulator said it "supports the development of a healthy and robust digital advice market in Australia as a convenient, low-cost option for retail clients, and our guidance will help ensure that consumers can have confidence when they deal with digital advice providers."

ASIC noted that only around 20 percent of Australians seek personal investment advice, so digital options could increase access to advice. Providers should take a user-focused approach and put the

client's needs first when designing communications and disclosure, ASIC said.

Europe has a generally positive stance. At the European Parliament's Committee on Economic and Monetary Affairs in November 2016, Jakub Michalik, of ESMA's legal division, said robo-advisors can "positively influence" the industry. The development of robo-advice dovetailed, he noted, with a move by regulators for a fairer and more transparent service to investors. Although robo-advice represents less than 1 percent of assets under management in Europe, ESMA expected this to rise to 25 percent by 2020.

In July 2016, the **UK** regulator created a dedicated robo-advisor unit to encourage new entrants. The FCA launched the unit after an "advice gap" emerged in the wake of the UK's Retail Distribution Review, the effects of which are still moving through the system. The regulator noted that automated advice models must meet the same standards as face-to-face advice.





... many may not understand the risks and investment features of products.



But automated advice tools not yet fully trusted

Robo-advice typically targets the low-end retail market, creating the risk that unsophisticated investors could receive poor financial advice or products that don't match their needs.

IOSCO in its report at the end of 2016 said the key regulatory concern is that consumers should receive appropriate advice, the same as for the face-to-face advice model. The use of technology raises the added concern that, if there is an error in programming or in the technological process, it may not be picked up without human intervention. Consumers will presume that their inputs and the software must be right, often without sense-checking.

IOSCO adds that many robo-advisors do not capture enough information about their clients, resulting in "simplistic" processes that are not suited to the client's needs. It says the questionnaires by which the platforms learn about customers are often "very short" and may not meet KYC requirements.

Most national regulators believe their existing rules are adequate. A number, though, are seeking to clarify the difference between general information, generic advice and personal recommendations, and are requiring regulated firms to disclose the type of service they are offering and its limitations. Some regulators acknowledge that their supervisory techniques must evolve too.

IOSCO noted that the majority of national regulators (Canada being a notable exception) have only limited information regarding the number of firms providing robo-advice and the number of customers and assets involved, because in many jurisdictions

it is not a regulated activity. However, regulators have some knowledge via regulated firms that offer such tools, while other regulators (e.g. in **Australia**) have launched exercises via their FinTech units that will capture more information.

In **Canada**, the OSC noted a significant increase in the number of firms seeking registration to operate online portals and trading platforms, and a number of registration deficiencies. The regulator underlined that regulatory requirements are "technology neutral".

OSC staff have also identified concerns with issues related to vulnerable investors – such as seniors – given their growing demographic importance, the fact that they are relying on investments to fund retirement costs, and that many may not understand the risks and investment features of products.

In **Europe**, the ESAs have published their final paper on automated advice platforms. The bodies previously published a Discussion Paper on automation in financial advice in December 2015, which said "regulatory and/or supervisory actions may be needed to mitigate the risks while at the same time harnessing the potential benefits". The term "advice" is not used with the narrow meaning in European regulation, but also encompasses "guided sales" and analytical tools.

Respondents to the Discussion Paper challenged suggestions that automated tools could provide wider access to advice, facilitate cross-border transactions or meet more complex client needs. They said divergent regulatory definitions of "advice" in the banking, securities and insurance sectors are a barrier to the development of automated advice.

The ESAs do not propose to develop additional cross-sectoral requirements for automated advice tools at this

time. However, firms that offer such tools should use the ESAs' checklist of risks for their design, implementation, monitoring and governance processes.

In the **US**, the growth of robo-advisor platforms has led to increased attention by regulators. They want to be sure that wealth management firms using these platforms are adhering to compliance requirements, such as proper distribution of account opening documentation and accurate disclosures of historical performance.

Many firms using traditional advisors and brokers have developed strong controls over account opening processes. But broker-dealers and other wealth management firms using robo-advisor platforms or client-directed portfolio construction tools need to ensure that their policies and procedures – and the actual delivery of products and services – are equally controlled.

Despite its welcoming words for robo-advice in 2016, the **UK's** FCA later in the year took a more challenging stance, saying it is examining whether action is required to monitor robo-advisors. Bank of England Governor Mark Carney warned that robo-algorithms could increase financial volatility.

Distributed Ledger Technology, the game changer

DLT has huge potential implications in the investment management industry for settlement, and for back and middle offices. As yet, the technology is largely untested, and this worries regulators, particularly given media stories about theft and criminal misuse of bitcoins. The case for DLT was not helped in March 2017 when the **US** SEC rejected an application for a bitcoin ETF, because "significant markets for bitcoin are unregulated"

Nevertheless, proponents are enthusiastic about the ability of DLT to improve the fund management industry. DLT allows a digital asset to be moved between counterparties without using a central ledger to record the transaction. 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.

In the investment management industry, it has the potential to speed up inefficient back offices processes and save billions in the amount of collateral that is required by the global financial system. DLT-based platforms can connect investors with fund firms and transfer agents. The transparent and immutable nature of this technology means it could be used to register subscriptions and redemptions of fund units, which could give fund houses greater visibility over who is invested in their products.



Regulators clamp down on social media

Social media is increasingly part of the marketing and distribution mix in the funds world, and has moved onto regulators' agendas. The **UK's** FCA, for instance, announced in October 2016 that firms must obey distribution rules, even on social media, in a move that may limit the attractiveness of Twitter for fund marketers.

Respondents to a consultation had asked the FCA to take into account the "whole customer journey" rather than each communication. But the regulator decided to stand firm on earlier guidance that interaction with consumers on social media must be "standalone compliant". It will not allow a promotion to include a click-through link showing extensive terms and conditions.

This media-neutral approach to financial promotions echoes that taken by other regulators. IOSCO said that because regulators' rules are largely principles-based and technology neutral, they should also apply to social media.

France's AMF said in May 2016 that rules governing traditional media apply equally to social media and that a specific regulatory framework would not be desirable. In **India**, social media are widely used by fund managers.

US's FINRA is also updating its social media guidance. In **Singapore**, meanwhile, MAS says it does not explicitly prohibit any forms of media from being used for marketing.

“ ... creates additional points of entry for malicious actors to compromise the confidentiality, integrity and availability of the ledger.” ”

New DLT-based platforms could respond to new regulation by automatically presenting information to the regulator as a transaction occurs. Regulatory changes like MiFID II and the second iteration of the Payment Services Directive will represent sizeable change for the investment management industry and challenge the current system by which managers incentivize distributors to sell their funds.

While other financial industries have found DLT to have “performance problems” due to its inability to handle a large amount of transactions at the same time, this is less likely to be an issue in the fund industry. And a number of tests have shown that mutual fund transactions can be made successfully using the technology, which is particularly suited to the mobile market.

DLT could disintermediate many industry participants and eliminate many back- and middle-office jobs. Industry incumbents are well-aware of this and are acting to ensure their businesses survive any shake-up by the technology. The majority of

consortia involved in the planned roll-outs have been set up by custodians and service providers. Several versions are expected to be rolled out from 2017 onwards.

Regulatory preparation is key to DLT roll-out

Investors are willing to embrace new technology, but regulators may be less prepared for its introduction. Integrating DLT with existing regulatory and legal frameworks is seen as the biggest challenge preventing its widespread adoption.

However, regulators are starting to address the issue. DLT has a long way to go before it can be fully realized, according to the ECB. Its committee on payments and market infrastructures said DLT could pose new risks to the financial system, including potential uncertainty about operational and security issues. Its report also cited potential legal and operational obstacles: “Having many nodes in an arrangement creates additional points of entry for malicious actors to compromise the confidentiality, integrity and availability of the ledger”

ESMA has also consulted on the application of DLT, aiming to identify its benefits, risks and challenges in securities markets and ways of addressing the risks. ESMA identified possible benefits in clearing and settlement, record of ownership and safekeeping of assets (including fund units), reporting and oversight, reduction of counterparty risk, efficient collateral management, continuous availability, security and resilience, and cost reduction. DLT might also be used to enhance pre-trade information and the matching of buyers and sellers.

DLT comes to funds

A DLT-based platform, enabling managers to sell funds directly to investors or on a business-to-business basis, has been rolled out in **Luxembourg**.

The platform is based on Ethereum, the world’s second largest DLT technology, and has been created in partnership between KPMG Luxembourg, Fundsquare and InTech. Fund managers are testing the platform and it is expected that the first live transactions will take place in the middle of 2017.

There are challenges and possible shortcomings in its use, though, ESMA believes. Technologically, these include scalability issues, interoperability with existing market infrastructure, the need to settle in central bank money, a recourse mechanism, gross positions (as opposed to netting), margin finance (which currently allows participants to transact with assets financed externally) and short selling of securities. Also, there are governance, privacy, regulatory and legal issues. In particular, the capacity of DLT to fit into the existing regulatory framework may limit its deployment (ESMA mentions over 10 different pieces of EU legislation it must fit within). The legality and enforceability of records needs careful consideration, too.

Key risks identified by ESMA are cyber, fraud, money laundering, operational, herding behavior (increased market volatility) and unfair competition.

ESMA suggests early applications will focus on optimizing processes using the current market structure, with likely first uses being in low-volume market segments and processes with minimal dependency on the existing legal framework. It said it would continue to monitor developments but believes that active engagement from regulators and co-ordination at EU and international level is paramount to ensure that applications of DLT do not create unintended consequences.

In February 2017, ESMA issued a follow-up report, which largely confirmed its information and thoughts in the consultation. Significantly, it believes the current EU regulatory framework is not an obstacle to DLT in the short term. However, a number of concepts or principles may require clarification.

In November 2016, the European Commission swung into action, launching a financial technology taskforce to look at all areas of financial technology, including DLT. It confirmed in February 2017 that



it would support activities that advance DLT. It is planning to develop experimental frameworks enabling innovation, as a part of the “Start-up and Scale-Up Initiative”, which aims to give entrepreneurs in DLT and FinTech every opportunity to become world-leading companies.

Also in November 2016, **France** started working on legislation that would allow funds to be distributed using DLT. It is the first European country to develop a legal framework governing its use for investment management. The French government is exploring extending rules passed earlier in 2016 permitting non-listed securities to be registered on a distributed ledger. The French treasury believes DLT will make it easier to sell funds across borders.

The **UK**, on the other hand, has adopted a different approach, setting up a regulatory “sandbox” and selecting a range of DLT-based services to take part in the project. The regulatory sandbox, or safe space, provides potentially ground-breaking technology with the support to test new ideas without imposing all the normal regulatory requirements.

Australia’s regulatory sandbox framework also allows FinTech to be tested without a license.

The **Netherlands** set up a regulatory sandbox in December 2016. As of the beginning of 2017, Dutch companies could also take advantage of partial authorization, authorization with requirements or restrictions, or an opt-in authorization.

In **Ireland**, the trade body for the funds industry has partnered with private firms to create a test environment distributed ledger for fund regulatory reporting. Irish Funds said in January 2017 it would test the application of DLT for improvements in compliance and transparency, as well as assessing any cost benefits of implementing the technology.

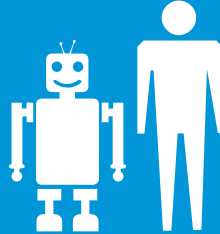
In **Singapore**, in conjunction with R3, a DLT technology company, and a consortium of financial institutions, MAS is working on a proof-of-concept project to conduct inter-bank payments using the technology.

Technology plays part in regulatory focus on data

In **Europe**, ESMA’s Supervisory Convergence Programme for 2017 includes data as one of its four main priorities.

Concerns of investment management CEOs

Ability to innovate as digital is changing the industry



85%

are concerned about integrating basic automated business processes with artificial intelligence and cognitive processes

81%

are not sure they are keeping up with technology

81%

say that managing data is increasingly important, and 81 percent of CEOs are concerned about the quality of data used in their decision-making

It believes data quality will be essential as NCAs prepare for and enforce compliance with the various reporting requirements under MiFID II/MiFIR⁴⁸, EMIR and AIFMD. It notes, for example, that poor quality of data in MiFIR transaction reports passed from one NCA to another will have a consequential impact on the receiving NCA's analysis. ESMA emphasizes focus on the development of supporting IT infrastructure.

In **Australia**, the prudential regulator (APRA⁴⁹) has written to pension fund trustees asking them to focus on data quality. The volume of claims of misconduct, mis-selling and poor advice indicate an issue, but too often, APRA said, firms cannot disprove claims against them as they do not have the data to evidence the contrary.

APRA has observed increased appetite by the superannuation industry to implement new business practices for administration, communication and account consolidation that are driven by new technologies. APRA encourages innovative approaches to engagement with members, but says schemes must identify, assess and manage the associated risks. This includes a prudent assessment of the materiality of outsourcing, with a particular focus on ensuring the security of member data.

APRA is concerned that schemes are providing bulk extracts of sensitive member data, including individual tax file numbers, to third-party service providers for business intelligence, customer analytics and marketing.

In **Europe**, the GDPR comes into force in spring 2018 and includes a number of new protections for EU data subjects' personal information. In particular, it imposes broader extra-territorial controls on the processing of personal data by non-EU controllers that collect personal data through the provision of services to EU citizens.

⁴⁸ Markets in Financial Instruments Regulation

⁴⁹ Australian Prudential Regulatory Authority

This is one of the many “third-country” provisions in EU regulation that will need to be navigated by European firms post-Brexit.

Switzerland’s regulator issued a circular that includes detailed conditions that must be met by intermediaries by June 2017 when they transmit non-public information to foreign entities. The Swiss Data Protection Act is also being revised.

Strong regulatory response to cybersecurity challenge

The **Irish** central bank has indicated it takes data requirements, and the increased risks around data, very seriously. Recent activity has been comprehensive. In September 2016, it issued cross-sectoral guidance on IT risk management and cybersecurity for financial services firms.

Boards and management of regulated firms are expected to take full responsibility for these issues and to make them a priority. Key issues firms need to address include the alignment of IT and business strategy, outsourcing risk, change management, cybersecurity, incident response, disaster recovery and business continuity.

The CBI is increasingly adopting a data-driven approach to supervision. It established a team of data analysts within its Securities and Markets Supervision Directorate to support frontline supervisors.

In particular, it has indicated it will increase its supervisory activities for low-impact entities. As a large proportion of fund managers and all investment funds are currently categorized as low impact, it is expected that they will be subject to more extensive engagement, with a focus on the quality of the data submitted in regulatory returns.



“... the regulatory threshold for AML is rising.”

How KPMG can help:

- cyber incident response services to support attack victims
- advice on technical aspects to help protect firms against attack
- advice on cyber incident response framework and processes
- exercises to test a firm's capabilities to detect, respond to and recover from cyber attack.

In the **UK**, the FCA sent out a Technology & Cyber Resilience Questionnaire in March 2017. It said it would use the information gained for insight into how firms are managing their technology resilience obligations and to determine appropriate supervisory approaches.

In the **US** alternatives industry, investment advisors face cyber risks from both internal and external sources, including employees, third parties, and others outside their organizations.

Cyber attacks on private equity firms and other companies had become so routine that some boards are reluctant to fund their chief information officers' request for additional resources, believing extra resources won't deter attacks and penalties cannot be averted.

The authorities are alarmed by the number and extent of attacks. New York Governor Andrew Cuomo announced the first-in-the-nation cybersecurity regulation. It took effect in March 2017 and requires firms to establish and maintain a cybersecurity program designed to protect consumers' private data and ensure the safety and soundness of New York's financial services industry.

In **Japan**, the JFSA was planning to conduct its first industry-wide exercise in 2017 to upgrade firms' capabilities against cyber-attacks.

The events of May 2017, which impacted key institutions in over 150 countries, have elevated cyber security as a priority issue.

Renewed focus on AML data

With the growth of technology and increased access to data, regulators are concerned that data could be leveraged for money laundering purposes. Therefore, the regulatory threshold for AML is rising.

In **Singapore**, increased focus on AML and combating the financing of terrorism (CFT) was the main theme of 2016. In August 2016, MAS set up two dedicated departments — a supervisory department and an enforcement department.

The supervisory department streamlines existing responsibilities for regulatory policies relating to money laundering and other illicit financing risks. It monitors money laundering risks and carries out onsite supervision.

The enforcement department centralized MAS's enforcement functions and jointly investigates capital markets misconduct offences with the Singapore Police Force's Commercial Affairs Department.

In **Europe**, the ESAs published in March 2017 an opinion on the risks of money laundering and terrorist financing. This opinion will contribute to the European Commission's risk assessment work as well as to the ESAs' work to foster supervisory convergence and create a level playing field in AML and CFT.

The opinion finds that problems exist in firms' understanding and management of the risks they are exposed to. It also said there is a lack of timely access to intelligence that might help firms identify and prevent terrorist financing, and considerable differences in the way national authorities deal with it.

These issues, if not addressed, risk diminishing the robustness of the EU's AML/CFT defenses. This is particularly important as Member States move towards a risk-based AML/CFT regime that requires a level of awareness and expertise that not all firms currently have. Several initiatives are already underway, including the ESAs' work on common risk-based AML/CFT supervision that, in the short to medium term, will address many of the risks identified.

EIMR abbreviations

AFM	Autoriteit Financiële Markten	G-SIFI	global systemically important financial institution
AIF	alternative investment fund (EU)	iDeCo	individual type Defined Contribution pension plan (Japan)
AIFM	alternative investment fund manager (EU)	IFRS	International Financial Reporting Standard
AIFMD	Alternative Investment Fund Managers Directive (EU)	IORPD II	Institutions for Organisational Retirement Provision Directive, revised (EU)
AMF	Autorité des Marchés Financiers (France)	IOSCO	International Organization of Securities Commissions
AML	anti-money laundering	IPO	initial public offering
APRA	Australian Prudential Regulatory Authority	JFSA	Japanese Financial Services Agency
ARFP	Asian Region Funds Passport	KID	Key Information Document (EU PRIIP)
ASEAN	Association of South-East Asian Nations	KIID	Key Investor Information Document (EU UCITS)
ASIC	Australian Securities and Investments Commission	KYC	know-your-customer
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)	LNAV	low volatility NAV (EU)
BVI	Bundesverband Investment und Asset Management (Germany)	MAD II	Market Abuse Directive, revised (EU)
CBI	Central Bank of Ireland	ManCo	management company (EU)
CCP	central counterparty	MAR	Market Abuse Regulation (EU)
CFT	countering the financing of terrorism	MAS	Monetary Authority of Singapore
CIS	collective investment scheme	MEP	Member of the European Parliament
CMU	Capital Markets Union (EU)	MiFID II	Markets in Financial Instruments Directive, revised (EU)
CNAV	constant NAV	MiFIR	Markets in Financial Instruments Regulation (EU)
CNMV	Comisión Nacional del Mercado de Valores (Spain)	MLP	Manager Led Product (Guernsey)
CPP	Canada Pension Plan	MMF	money market fund
CRD IV	Capital Requirements Directive, revised (EU)	MoC	memorandum of cooperation
CSA	Canadian Securities Administrators	MRF	Mutual Recognition of Funds (China Mainland-Hong Kong)
CVM	Comissão de Valores Mobiliários (Brazil)	NAV	net asset value
DLT	distributed ledger technology	NCA	National Competent Authority (EU national regulator)
EBA	European Banking Authority	OCIE	Office of Compliance Inspections and Examinations (US)
ECB	European Central Bank	OECD	Organisation for Economic Co-operation and Development
EEA	European Economic Area	OEIC	open-ended investment company
EFAMA	European Fund and Asset Management Association	OSC	Ontario Securities Commission (Canada)
EIMR	Evolving Investment Management Regulation (KPMG International)	OTC	over-the-counter
ELTIF	European Long-Term Investment Fund	PIF	Private Investment Fund (Guernsey)
EMIR	European Market Infrastructure Regulation	Pir	Piano individuale di risparmio (Italy)
ESAs	European Supervisory Authorities	PRIIP	Packaged Retail Investment and Insurance-based Product (EU)
ESMA	European Securities and Markets Authority	PRISM	Probability Risk and Impact System (Ireland)
ETF	exchange-traded fund	RQFII	Renminbi Qualified Foreign Institutional Investor (China)
EU27	EU Member States excluding the UK	RTS	Regulatory Technical Standard (EU)
EuSEF	European Social Entrepreneurship Fund	SEBI	Securities and Exchange Board of India
EuVECA	European Venture Capital Fund	SEC	Securities and Exchanges Commission (US)
FCA	Financial Conduct Authority (UK)	SFC	Securities and Futures Commission (Hong Kong)
FINRA	Financial Industry Regulatory Authority (US)	SFTR	Securities Financing Transactions Regulation (EU)
FIP	Fondo Investimenti Piemonte (Brazil)	SICAV	société d'investissement à capital variable (EU)
FSB	Financial Stability Board	SME	small- to medium-sized enterprise
FSCA	Financial Sector Conduct Authority (South Africa)	SRI	socially-responsible investment
FSI	Financial System Inquiry (Australia)	UCITS	Undertaking for Collective Investment in Transferable Securities (EU)
GDPR	General Data Protection Regulation (EU)	VNA	variable NAV
GIPS	Global Investment Performance Standards		

Acknowledgments

Americas region

Marco Andre Almeida

KPMG in Brazil

T: +55 21 3515 9404

E: maalmeida@kpmg.com.br

Oliver E Cunningham

KPMG in Brazil

T: +55 11 3940 3115

E: oecunningham@kpmg.com.br

Peter L Hayes

KPMG in Canada

T: +1 416 777 3939

E: phayes@kpmg.ca

Erick Morales

KPMG in Mexico

T: +52 555 246 8887

E: erickmorales@kpmg.com.mx

Nicolas Olea

KPMG in Mexico

T: +52 555 246 8678

E: olea.nicolas@kpmg.com.mx

Mark McKeever

KPMG in the US

T: +1 267 256 1704

E: mmckeever@kpmg.com

Tracy L Whille

KPMG in the US

T: +1 212 954 2691

E: twhille@kpmg.com

Asia-Pacific region

Jacinta Munro

KPMG in Australia

T: +61 392885877

E: jacintamunro@kpmg.com.au

Samantha Kim

KPMG in Australia

T: +61 293358633

E: samanthakim@kpmg.com.au

Cecilia Storniolo

KPMG in Australia

T: +61 293358274

E: cstorniolo@kpmg.com.au

Sean D Hill

KPMG in Australia

T: +61 3 9288 6948

E: seanhill@kpmg.com.au

Abby Wang

KPMG in China

T: +86 2122122428

E: abby.wang@kpmg.com

Wilson Huang

KPMG in China

T: +86 2122122409

E: wilson.huang@kpmg.com

Arion Yiu

KPMG in Hong Kong

T: +85 221438599

E: arion.yiu@kpmg.com

Seiji Kamiya

KPMG in Japan

T: +81 335485107

E: seiji.kamiya@jp.kpmg.com

Ryuichi Murasawa

KPMG in Japan

T: +81 335485107

E: ryuichi.murasawa@jp.kpmg.com

James Chong

KPMG in Malaysia

T: +60 37721 3388

E: jameschongwc@kpmg.com.my

Shahid Zaheer

KPMG in Singapore

T: +65 64118923

E: szaheer@kpmg.com.sg

David Waller

KPMG in Singapore

T: +65 62133007

E: davidwaller@kpmg.com.sg

Europe, Middle East and Africa region

Peter Coox

KPMG in Belgium
T: +32 38 211705
E: pcoox@kpmg.com

Benoit Van den Broeck

KPMG in Belgium
T: +32 38211716
E: bvandenbroeck@kpmg.com

Koen de Loose

KPMG in Belgium
T: +32 27084317
E: kdelloose@kpmg.com

Marie-Helene Angelides

KPMG in Cyprus
T: +35 722209000
E: helene.angelides@kpmg.com.cy

Christiana Loizou

KPMG in Cyprus
T: +35 722209000
E: christiana.loizou@kpmg.com.cy

Nicolas Clot

KPMG in France
T: +33 155687535
E: nclot@kpmg.fr

Axelle Ferey

KPMG in France
T: +33 155687535
E: aferey@kpmg.fr

Gerard Gaultry

KPMG in France
T: +33 155687030
E: ggaultry@kpmg.fr

Markus Lange

KPMG in Germany
T: +49 69 951195-530
E: markuslange@kpmg-law.com

Elmar Schobel

KPMG in Germany
T: +49 69 9587-1700
E: eschobel@kpmg.com

Matthias Neuf

KPMG in Germany
T: +49 69 95873627
E: mneuf@kpmg.com

Chris Thoume

KPMG in Guernsey
T: +44 1481755714
E: cthoume@kpmg.com

Russell Kelly

KPMG in Isle of Man
T: +44 1624681013
E: russellkelly@kpmg.co.im

Giuseppe D'Antona

KPMG in Italy
T: +39 0267643516
E: gdantona@kpmg.it

Niamh Mulholland

KPMG in Ireland
T: +353 17004785
E: niamh.mulholland@kpmg.ie

Margaret Murphy

KPMG in Ireland
T: +353 17004016
E: margaret.murphy@kpmg.ie

Don Scott

KPMG in Ireland
T: +353 17004756
E: don.scott@kpmg.ie

Milind Ranade

KPMG in India
T: +91 2230902484
E: milind@kpmg.com

Naresh Makhijani

KPMG in India
T: +91 2239896000
E: nareshmakhijani@kpmg.com

Oliver Morris

KPMG in Jersey
T: +44 1534608483
E: omorris@kpmg.com

Gabrielle Jaminon

KPMG in Luxembourg
T: +35 22251517635
E: gabrielle.jaminon@kpmg.lu

Anne-Sophie Minaldo

KPMG in Luxembourg
T: +35 22251517909
E: anne-sophie.minaldo@kpmg.lu

Dee Ruddy

KPMG in Luxembourg
T: +35 22251517369
E: dee.ruddy@kpmg.lu

Sarah Camilleri

KPMG in Malta
T: +35 625631273
E: sarahcamilleri@kpmg.com.mt

Lennart Cattel

KPMG in the Netherlands
T: +31 206 562949
E: cattel.lennart@kpmg.nl

Rob Voster

KPMG in the Netherlands
T: +31 206568439
E: voster.rob@kpmg.nl

Roel Menken

KPMG in the Netherlands
T: +31 206 564081
E: menken.roel@kpmg.nl

Gustaaf Kruger

KPMG in South Africa
T: +27 827191730
E: gustaaf.kruger@kpmg.co.za

Pablo Bernad

KPMG in Spain
T: +34 914563871
E: pablobernad@kpmg.es

Francisco Uria

KPMG in Spain
T: +34 914513067
E: furia@kpmg.es

Sven Hoglund

KPMG in Sweden
T: +46 87239777
E: sven.hoglund@kpmg.se

Pascal Sprenger

KPMG in Switzerland
T: +41 582494223
E: psprenger@kpmg.com

Sandra Gasser

KPMG in Switzerland
T: +41 58 249 53 15
E: sgasser@kpmg.com

Rizwan Yaseen

KPMG in Qatar
T: +974 44576444
E: ryaseen@kpmg.com

Priya Dugar

KPMG in the UAE
T: +97 144030357
E: pdugar@kpmg.com

Luke Ellyard

KPMG in the UAE
T: +97 144030322
E: lellyard@kpmg.com

Jon Hogan

KPMG in the UK
T: +44 20 76942258
E: Jon.Hogan@kpmgifrg.com

Contacts

Jeremy Anderson
Chairman
Global Financial Services
KPMG International
T: +44 20 7311 5800
E: jeremy.anderson@kpmg.co.uk

Tom Brown
Global Head of Asset Management
KPMG International
T: +44 20 7694 2011
E: tom.brown@kpmg.co.uk

Fiona Fry
Head of Financial Services
Regulatory Center of Excellence
EMA region
KPMG in the UK
T: +44 20 76942364
E: fiona.fry@kpmg.co.uk

Simon Topping
Head of Financial Services
Regulatory Center of Excellence
ASPAC region
T: +85 2 2826 7283
E: simon.topping@kpmg.com

Deborah Bailey
Head of Financial Services
Regulatory Center of Excellence
Americas region
KPMG in the US
T: +1 202 533 3443
E: dpbailey@kpmg.com

Julie Patterson
Head of Asset Management
Regulatory Change Financial Services
Regulatory Center of Excellence
EMA region
T: +44 20 73112201
E: julie.patterson@kpmg.co.uk

Bonn Liu
Head of Asset Management
ASPAC region
T: +85 2 2826 7241
E: bonn.liu@kpmg.com

James Suglia
National Sector Leader Alternative Investments
KPMG in the US
T: +1 617 988 5607
E: jsuglia@kpmg.com

Larry Godin
Principal
Advisory, Regulatory Risk
KPMG in the US
T: +1 212 954 1939
E: lgodin@kpmg.com

kpmg.com/eimr

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