Products: new rules, new opportunities

Evolving Investment Management Regulation

2017

KPMG International

kpmg.com

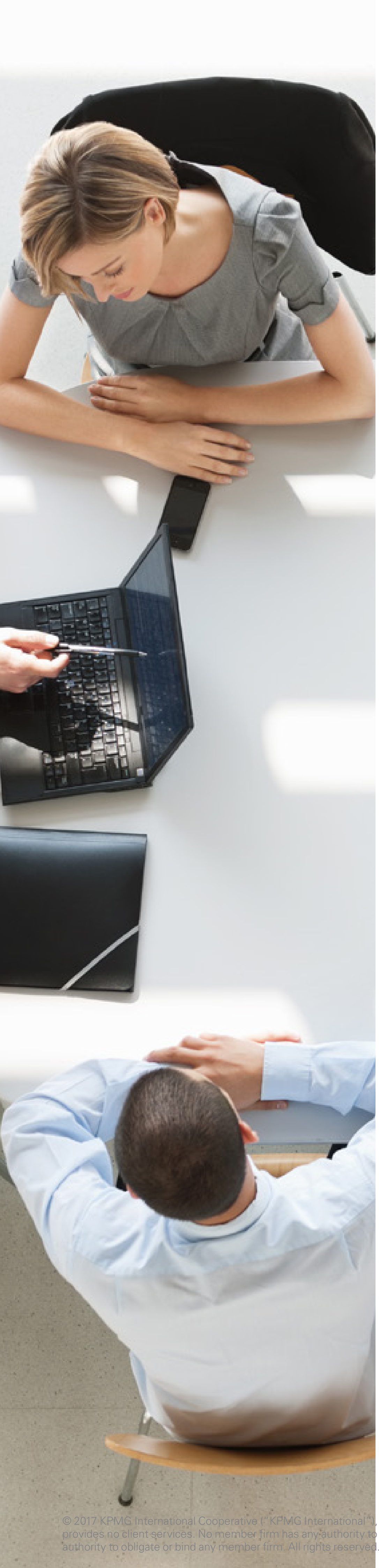
This article forms part of the Evolving Investment Management Regulation report, available at: kpmg.com/eimr

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, advised[1] 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

[1] 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 OSC[2] 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

[2] Ontario Securities Commission

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 (AFM[3]) 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.

[3] 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**, EuVECAs 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 SRI[4] 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.

[4] 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 MEPs[5] 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 OECD[5] 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 IFRS[7].

[5] Member of the European Parliament
[6] Organisation for Economic Co-operation and Development
[7] 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 SICAV[8] in continental Europe or the OEIC[9] 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.

[8] Société d'investissement à Capital Variable
[9] Open-Ended Investment Company

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

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

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

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

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

Join the conversation #eimr

Designed by Create Graphics | CRT078553