



Scrutiny of corporate behavior is not waning

**Evolving Investment
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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 FSCA¹). 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

¹ 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 SFC², 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.



² 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.

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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.

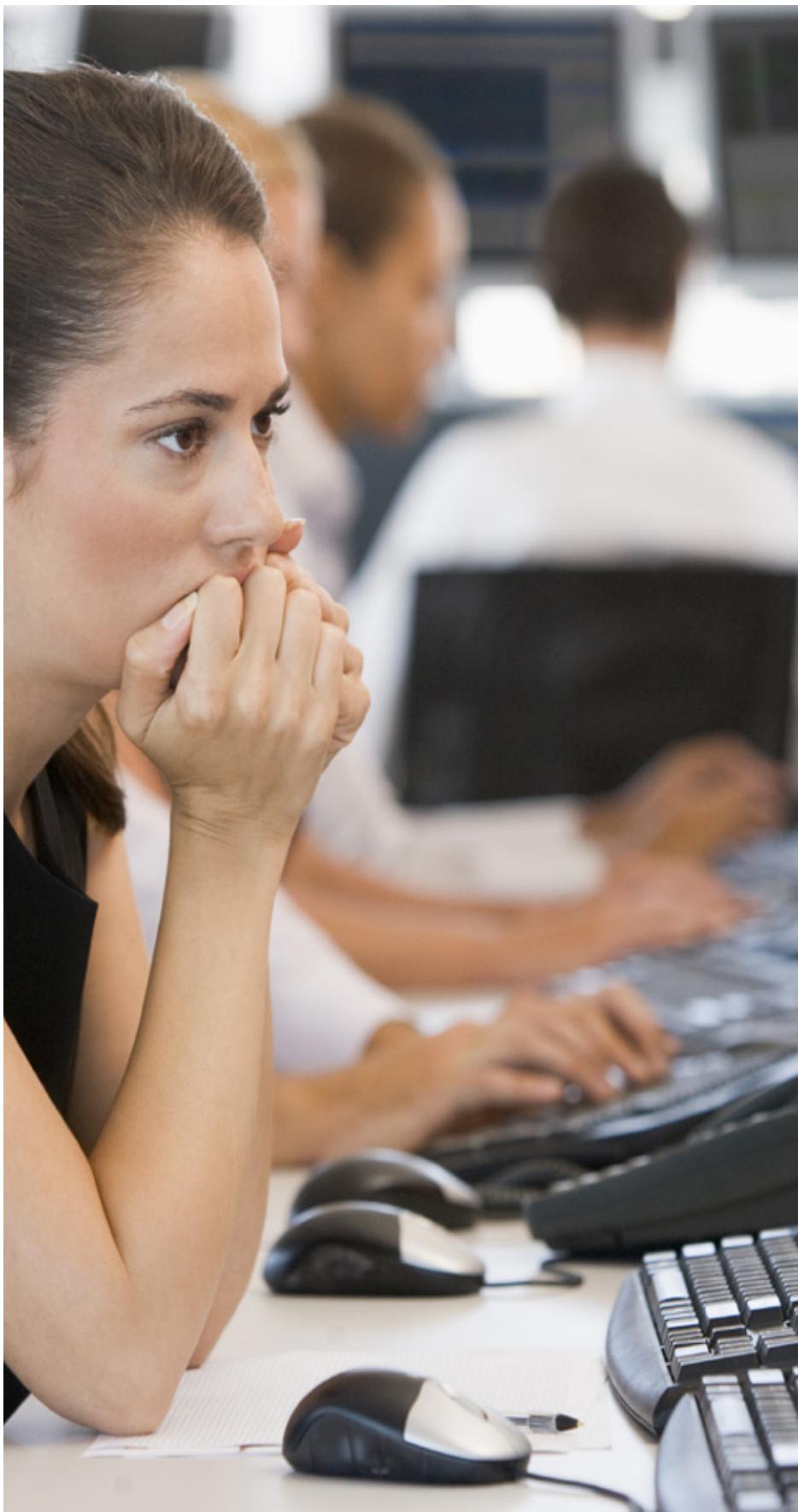
US wealth managers feel the heat

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, FINRA³ 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



³ Financial Industry Regulatory Authority

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



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-Branche 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
- 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 CNMV⁴ 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 IV⁵, for example, is already underway, although the planned review of AIFMD has been delayed.

Meanwhile, regulators are focusing on compliance with existing rules.

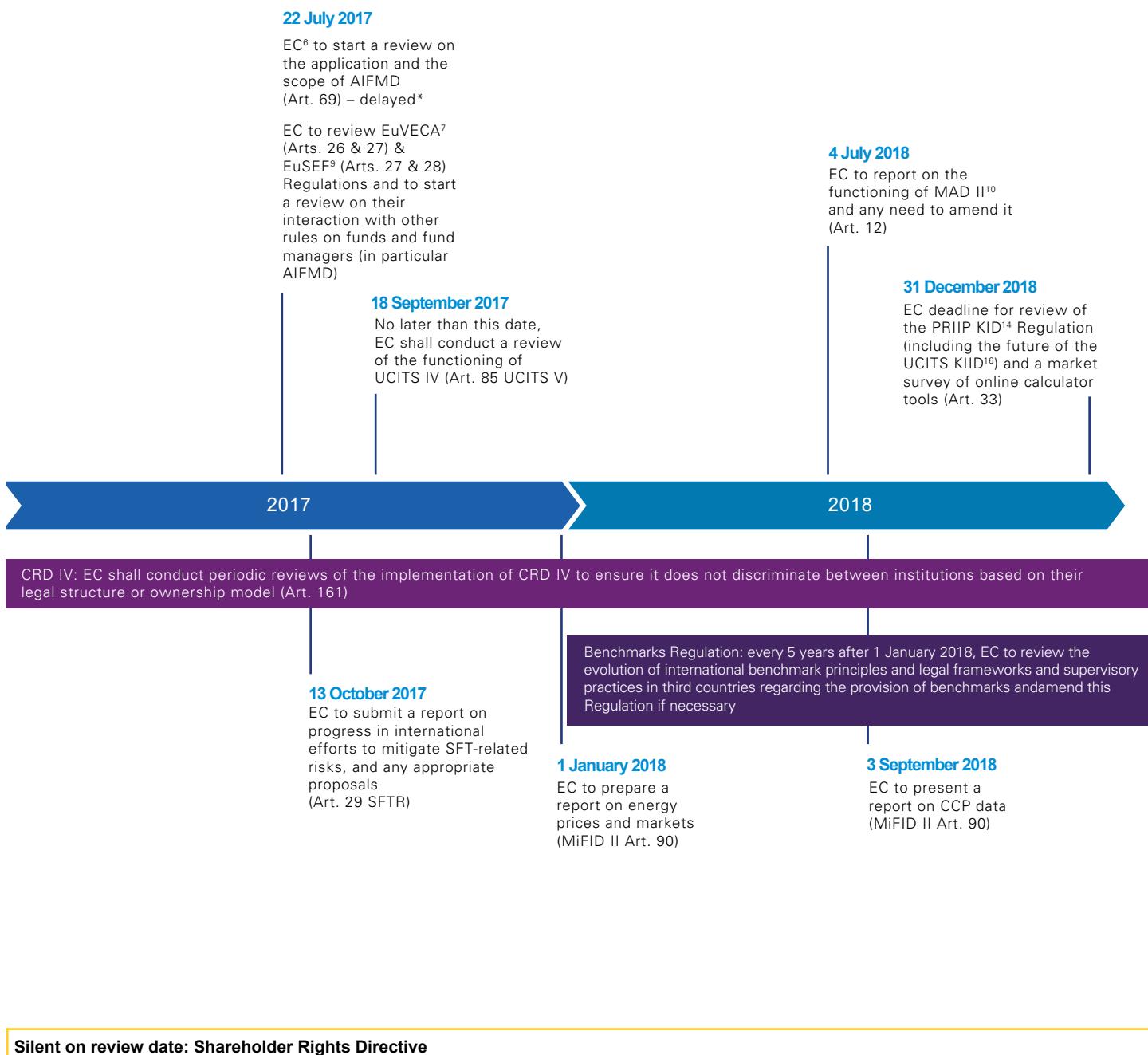
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⁴ Comisión Nacional del Mercado de Valores

⁵ Capital Requirements Directive, revised

EU regulation – review timeline



* 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.

⁶ European Commission

⁷ European Venture Capital Fund

⁸ European Social Entrepreneurship Fund

⁹ Market Abuse Directive, revised

¹⁰ Market Abuse Regulation

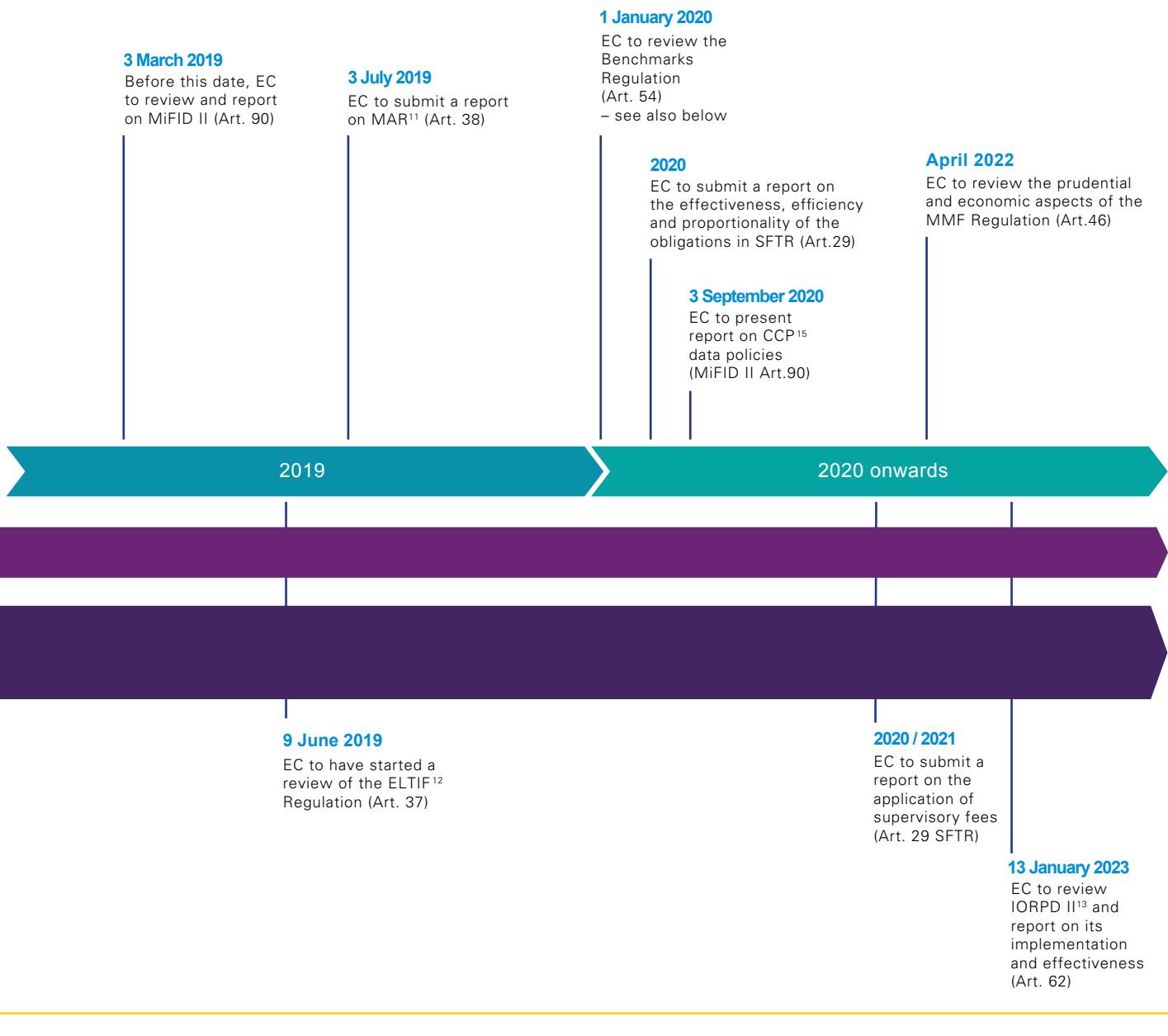
¹¹ European Long-Term Investment Fund

¹² Institutions for Occupational Retirement Provision Directive, revised

¹³ Packaged Retail Investment and Insurance-based Products, Key Information Document

¹⁴ Central Counterparties

¹⁵ Key Investor Information Document



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