



Systemic risk: the regulatory end-game is close

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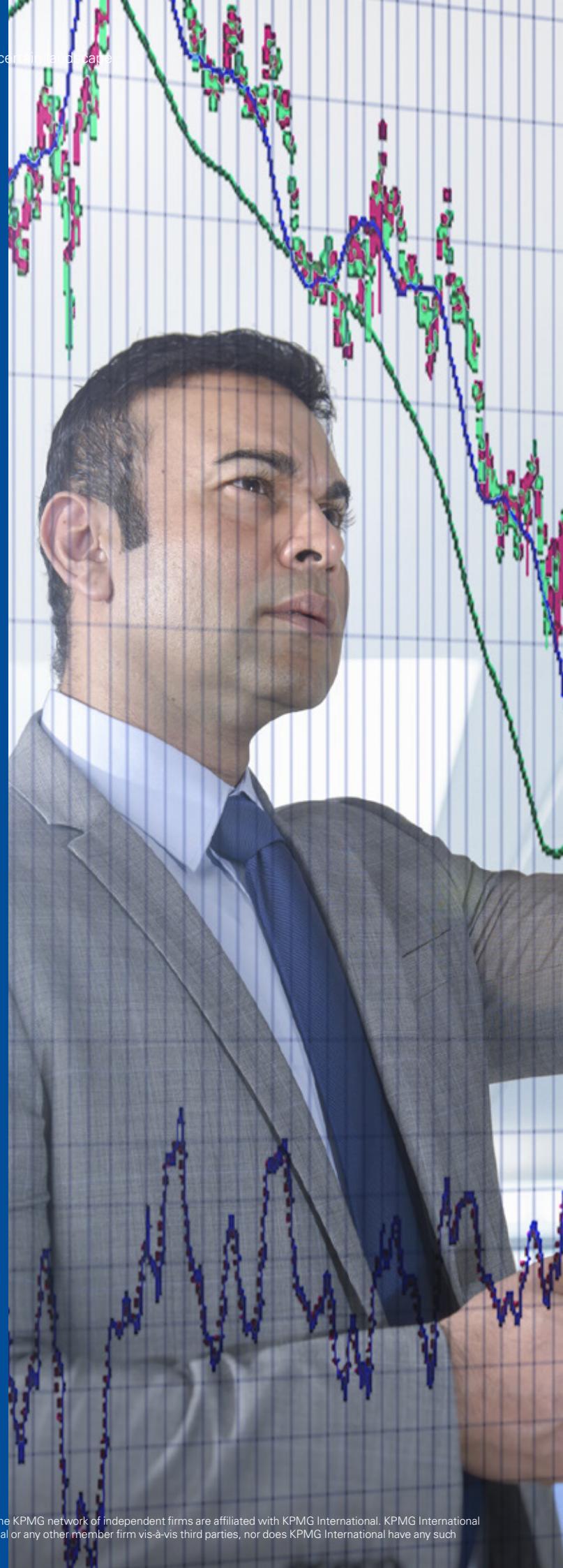
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The systemic risk debate has swung to and fro in recent years. Last year, we noted that international agencies had softened their stance on the investment management sector, moving away from designating investment firms as systemically important.

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 FSB¹ 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 IOSCO² has called for more data on derivatives use, leverage, liquidity and portfolio composition.

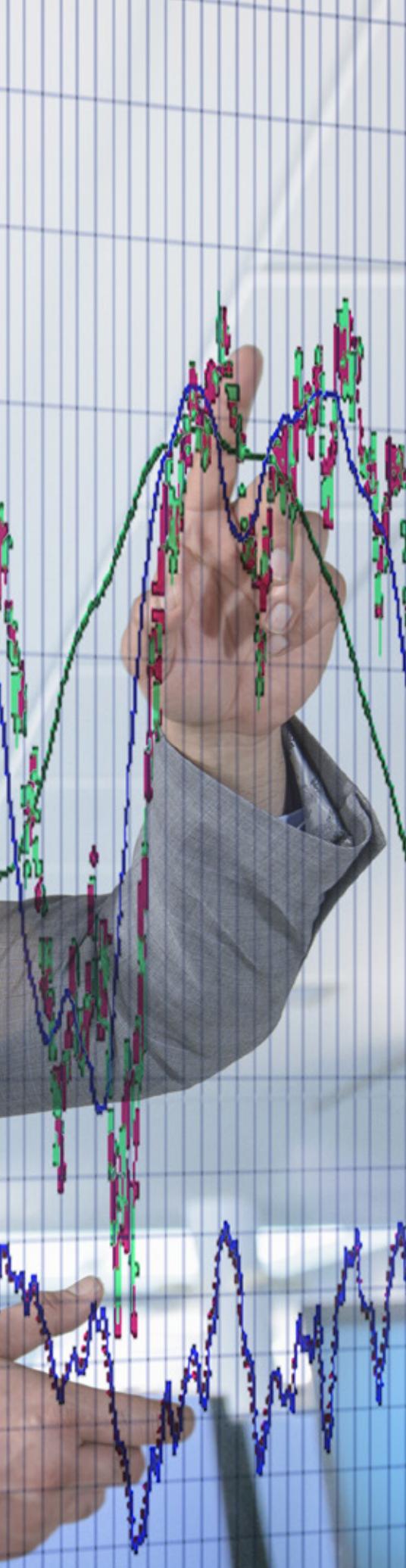
The protracted post-financial crisis debate on the regulation of MMFs³ is also drawing to a close, but questions have now arisen about the possibility of significant amendments to the US Dodd-Frank Act, a key plank of the US response to the G20 post-crisis regulatory agenda.



¹ Financial Stability Board

² International Organization of Securities Commissions

³ money market funds



State-of-play on systemic risk

The ECB⁴, 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 AIFMD⁵ 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.

⁴ European Central Bank

⁵ 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.

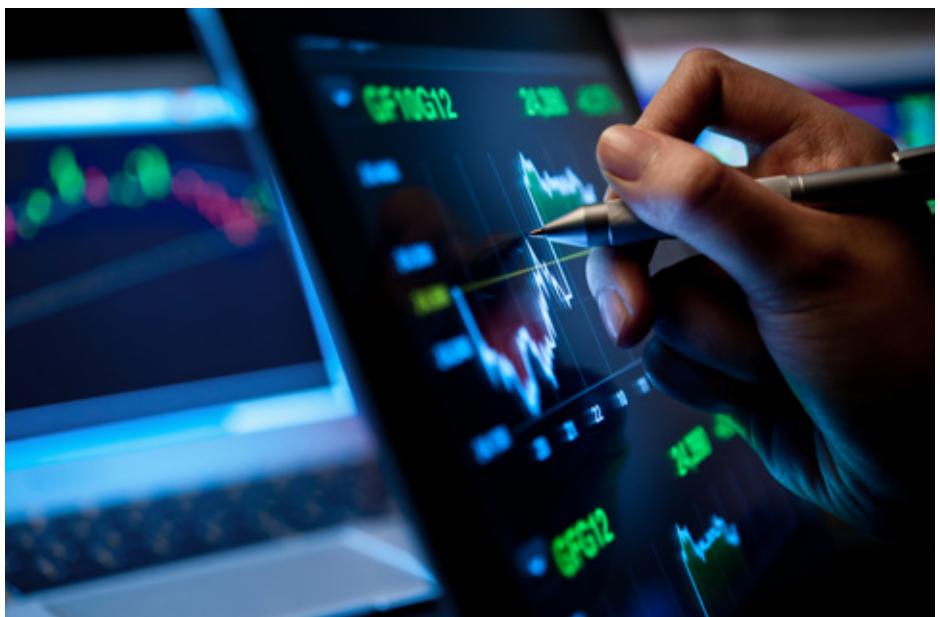
Its re-entry into the debate was not surprising. It had indicated in 2015 that it was in favor of a systemically-important label. It adjusted its stance later that year, saying it had moved towards IOSCO's position, which does not seek to focus on specific investment firms but on activities. Indeed, 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 NAV⁶.
- Two new reports must be filed on a monthly and annual basis with the SEC⁷. 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.

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 supranational edicts. In July 2016, **France**'s financial regulator (AMF⁹) issued draft guidelines on best practice for the stress testing of funds, both UCITS and AIFs¹⁰.

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".

National regulators take matters into their own hands

In **Europe**, ESMA⁸ 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 Maijor said ESMA would consider stress testing in the European fund industry, as recommended by the FSB. But he added that ESMA's

⁶ Net Asset Value

⁷ Securities and Exchanges Commission

⁸ European Securities and Markets Authority

⁹ Autorité des Marchés Financiers

¹⁰ 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 (CVM¹¹) 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.



¹¹ 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 OTC¹² derivatives positions (different to calculations under EMIR¹³)
- 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 (JFSA¹⁴) 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 (BaFin¹⁵) 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.

¹² Over-the-counter

¹³ European Market Infrastructure Regulation

¹⁴ Japanese Financial Services Agency

¹⁵ Bundesanstalt für Finanzdienstleistungsaufsicht

Steven Maijor, 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 ESAs¹⁶) 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.



¹⁶ 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.

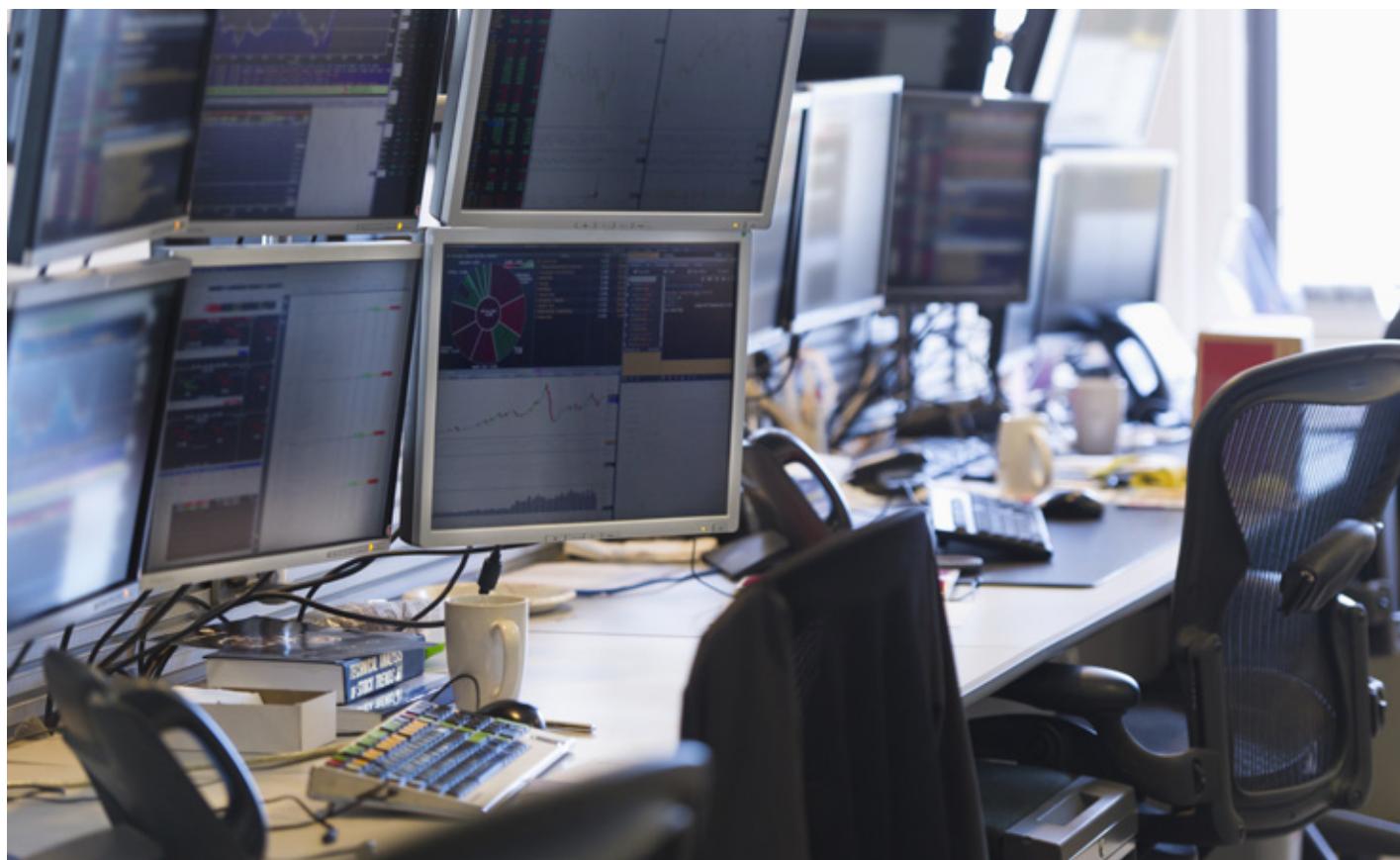
Meanwhile, in **China**, MMF reforms have made the country's financial sector safer but risks remain, warned Fitch Ratings. MMFs are particularly vulnerable when conditions deteriorate and bond prices are volatile, said Fitch. Regulation announced in December 2015 has dampened the effect of the bond 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 depositary



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.

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