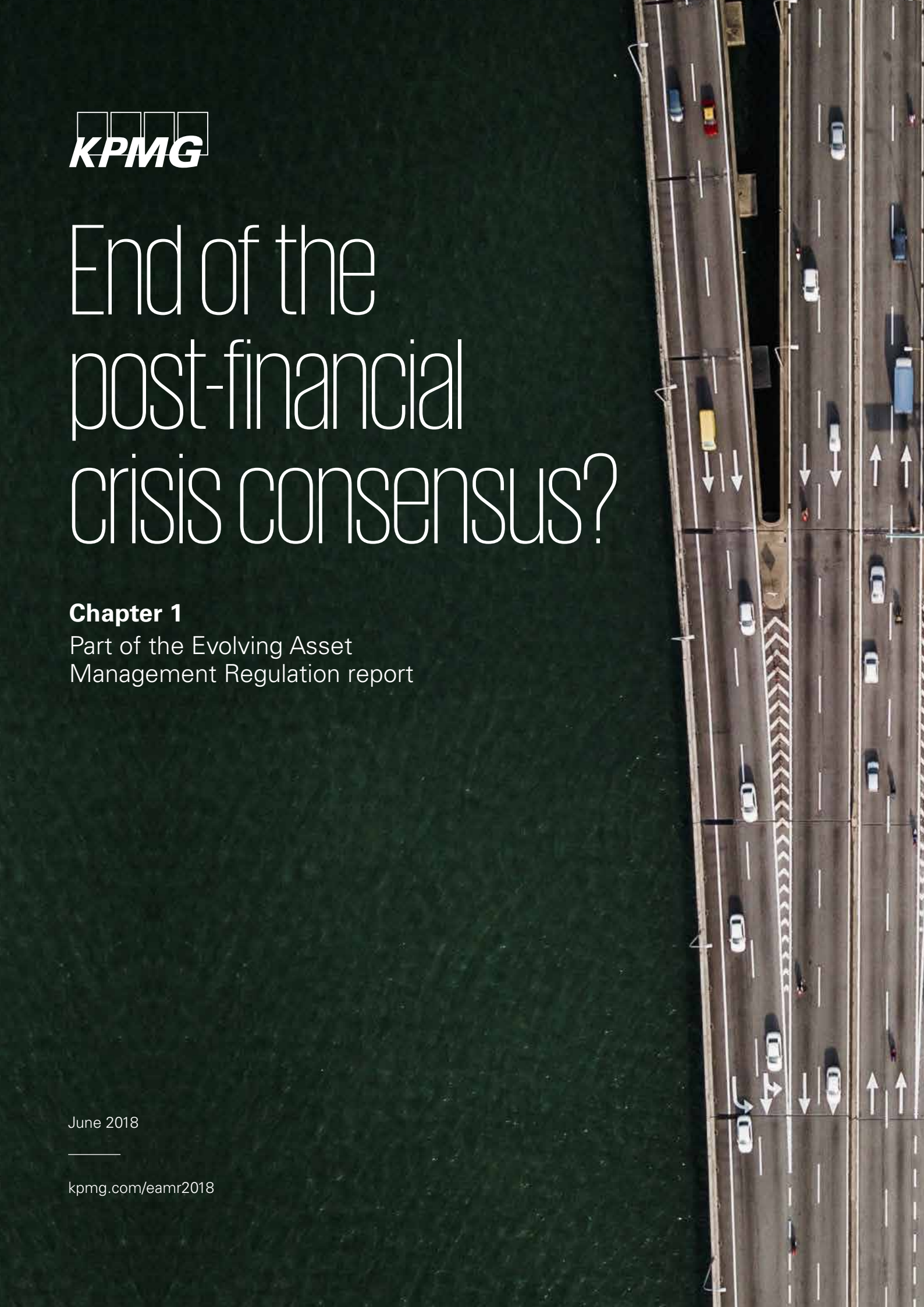

KPMG

End of the post-financial crisis consensus?

Chapter 1
Part of the Evolving Asset Management Regulation report

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End of the post-financial crisis consensus?

Europe and the **US** have long played different mood music in terms of regulation and the need to control markets. But in the aftermath of the financial crisis, US, European and **Asian** policymakers were pretty much agreed about the need for rule-making to reduce systemic risk. Their shared aims were to enhance the integrity of markets and to reduce risks for individual and end-investors. Less than a decade later, that consensus appears to be gone.

The US Treasury believes the consensus now encumbers the huge US asset management industry, which dominates at both domestic and global levels. There is now a desire to deregulate and take a path that forks dramatically from that of global regulators in general and of the EU in particular.

Meanwhile, US and other regulators around the globe are evolving their supervisory approach and seeking increased resources, but for different reasons.

US Treasury review is a game-changer

In a long and carefully-worded Treasury report[1], the US has made it clear that the US asset management sector should no longer be part of the domestic and global regulatory edifice that has been built since 2008. The principal goals are to remove the suggestion that asset management is systemically risky, and to reduce the burden of regulation and compliance on investment firms.

The report to the President, published with little fanfare, has the potential to change the global asset management dynamic. Called "A Financial System That Creates Economic Opportunities – Asset Management and Insurance", it sets out core principles that are squarely focused on growth and opposed to measures that restrict the industry.

> "A median increase in compliance costs of about 20 percent over the past five years"

The Treasury sees the costs of asset management soaring by 2022. The reasons for rising costs are diverse, with commercial cost pressures increasing as firms expand distribution networks and costs rising for product development, technology and data management. However, one of the most important drivers is the cost of complying with an increased regulatory burden following the financial crisis.

The Treasury notes that the asset management sector has seen a median increase in compliance costs of about 20 percent over the past five years arising from additional requirements, such as the SEC[2] money market fund rule reforms, enhanced fund reporting, liquidity rulemaking, the Department of Labor (DoL) fiduciary rule, new SRO[3] rules, and requirements related to Dodd-Frank[4] and other compliance regimes. Many of these costs are passed along to individual retail investors in the form of expenses.

Other US regulators, such as the Commodity Futures Trading Commission (CFTC), have added regulatory burdens on the asset management industry, as has compliance with the reporting of the cost basis of mutual fund shares under new Inland Revenue Service rules.

Moreover, the global nature of the largest asset management firms creates the need to comply with foreign laws and regulations. The costs involved, said the Treasury, represent an opportunity cost, diverting resources away from efforts to boost portfolio returns, risk management and improved customer service.

The US Treasury's recommendations are being considered by the various agencies. A number of new rules, which were due to take effect this year, have already been put on hold. And in May 2018, the US House of Representatives passed a Bill (already passed by the Senate) amending parts of Dodd-Frank. The Bill leaves much of Dodd-Frank unchanged but it extends various exemptions and raises certain thresholds, below which the requirements do not apply.

In a separate twist, in March 2018 a federal appeals court overturned the DoL fiduciary rule[5], arguing that the DoL had exceeded its authority. Responses have been mixed, with some welcoming the decision as they believe the rule introduced additional costs for investors, while others are concerned that ordinary investors are left unprotected.

In April 2018, the SEC[6] responded. A majority of the Commissioners voted to propose a package of rules and guidelines to improve broker-client relationships. A broker-dealer should not put its financial interests ahead of the interests of a retail customer when making recommendations. Guidance seeks to clarify the regulator's views of the fiduciary duties that investment advisors owe to their clients.

In addition, the SEC proposes to restrict the use of the titles "advisor" and "adviser" by broker-dealers and their representatives, and to introduce a mandatory new disclosure document that sets out the terms of advisory relationships. However, critics say that the proposal falls short of a full fiduciary rule.

[1] https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf
[2] Securities and Exchanges Commission
[3] self-regultory organisation
[4] US Dodd-Frank Wall Street Reform and Consumer Protection Act
[5] http://www.ca5.uscourts.gov/opinions/pub/17/17-10238-CV0.pdf
[6] https://www.sec.gov/news/press-release/2018-68

The national detail

The Treasury report called for a rollback of national regulation in the following areas:

Liquidity Risk Management

The Treasury rejects any "highly prescriptive" regulatory approach to liquidity risk management. The SEC should, it said, postpone the currently scheduled December 2018 implementation of Rule 22e-4, which requires mutual funds to adopt a liquidity risk management program. Under this rule, funds would be required to monitor the liquidity risk of their portfolio and determine a minimum percentage of their assets that must be invested in highly liquid investments. Each fund would be required to classify each of its portfolio investments into one of four defined liquidity categories, known as "buckets."

However, concerns have arisen, said the Treasury, regarding the rule's approach to measuring liquidity risk and the costs involved in implementing the rule. The rule mandates an overly prescriptive asset classification or bucketing methodology, it believes, which may not help funds to improve their liquidity risk management programs.

Derivatives

The Treasury believes portfolio limits could unnecessarily restrict funds from using derivatives, even for hedging or other risk mitigation. Limiting available risk management and liquidity tools would result in less efficient asset management, higher transaction costs and lower returns, it said. The result could be the closure of funds or forced changes to investment strategies, which would disrupt current business practices and reduce investor choice.

The Treasury recommended the SEC consider an asset segregation requirement and a rule that includes a derivatives risk management program, but it should reconsider the scope of assets included and whether portfolio limits are appropriate. Any portfolio limits should be based on significantly more risk-adjusted measures of a fund's derivatives than the current proposal. Also, the SEC should examine the derivatives data that will be reported by funds, starting in 2018, and publish an analysis based on empirical data.

The Volcker Rule

The Treasury wants regulators to reduce the burden of the Volcker Rule on asset managers and investors. They should refrain, said the Treasury, from enforcing the Volcker Rule's proprietary trading restrictions, given that foreign private funds are not "covered funds" under the rule.

In Business Continuity and Transition Planning

June 2016, the SEC proposed a new rule (206(4)-4) under the Advisers Act that would require registered investment advisers to adopt and implement written business continuity and transition plans. The rule has not been finalized. The Treasury said that with the existing principles-based rule already in place, there is no compelling need for additional rulemaking in this area. It encouraged the SEC to withdraw its proposal and, instead, to recommend improvements to business continuity plans.

Dual SEC and CFTC Registration

In 2012, the CFTC required certain investment companies and advisers to register with it, even if they were already required to register with the SEC. The Treasury wants this dual registration and regulation to cease. It also recommended that the CFTC and the SEC co-operate to share information.

Fund disclosures and reporting

The Treasury noted that the Securities Act, the Exchange Act and the 1940 Act impose an "extensive set of disclosure requirements" on registered investment companies so that investors can make informed investment decisions. However, delivering these disclosures on paper comes at significant expense, the Treasury believes, which is paid out of fund assets.

Regulatory requirements must adapt to advances in technology and increased access to the internet across the US, the Treasury said, noting that 84 percent of US adults have access to the internet and 92 percent of all mutual fund-owning households have access.

> duplicative reporting requirements can add considerable burden and costs to funds that are passed on to investors.

The delivery of fund reports and other materials by electronic means, such as a website, would enable significant cost savings, it said. Electronic delivery could also enable a greater level of detail and information to reach investors through an online platform that would likely enhance the user experience and provide greater educational value. For fund shareholder reports alone, such a change could save investors up to USD 2 billion over the next 10 years, while reducing environmental waste.

In addition, duplicative reporting requirements can add considerable burden and costs to funds that are passed on to investors. These include multiple types of required reporting formats that essentially request the same information, but in a slightly different manner or based on different timing. For example, some reports are based on calendar year while others use the fiscal year. The effect of these duplicative and onerous regulatory requirements serves to artificially inflate costs, the Treasury noted.

It said the SEC, the CFTC, SROs and other regulators should work together to rationalize and harmonize the reporting regimes.

The US view on international engagement

In some cases, the **US** Treasury observes, the FSB[7] has gone beyond its core mission of enhancing global financial stability. For example, it argues, the FSB has introduced extensive work streams to address firm-level misconduct risk, monitor compensation structures and evaluate governance frameworks, all of which appear more supervisory than related to financial stability.

A second example is the FSB's efforts to work on climate-related financial disclosures, on which the FSB convened a taskforce. The Treasury "strongly believes" that the FSB's objectives should be focused on its mission of enhancing global financial stability.

The FSB is not sufficiently transparent, the Treasury believes. Although the FSB has published consultative drafts of some proposed policies, these consultations are not subject to requirements comparable to the US Administrative Procedure Act. Also, FSB consultative drafts and other policy papers generally do not disclose whether the responsible party for drafting such papers is from the FSB secretariat or from an FSB member agency.

Additionally, the FSB's meetings with industry are generally invitation-only during public consultation periods and without public records of discussions. Commenters on FSB policy recommendations can request confidential treatment, which further restricts the ability of the public to benefit from responses of commenters. Thus, the public may not have full insight as to the analysis and data that the FSB is considering.

There is also no FSB requirement to conduct pre-implementation economic analysis. Unlike in the US, where agencies conducting rulemaking must examine all relevant data provided by interested persons after the notice and comment period has ended and articulate a basis for their actions, the FSB is not required to do so.

[7] Financial Stability Board

Meanwhile, other countries forge ahead with new rules

In contrast, Europe, Asia and, to some extent, other parts of the globe, are continuing down the path set by post-financial crisis regulation. That's to say, they are now on a divergent path from that of the US. They are taking on board the outputs of IOSCO[8] and are pursuing regional and domestic regulatory initiatives.

In **Europe**, in particular, the implementation of rules that have been years in the making has reached peak intensity. These rules tend to collect around the twin peaks of financial stability and investor protection, for which MiFID II[9] is the key – but not the only – conduit.

> "Europe, Asia and, to some extent, other parts of the globe, are continuing down the path set by post-financial crisis regulation."

It is clear that some regulators are struggling to respond to the weight and complexity of regulation. **Spain**'s financial regulator, for one, said it planned to increase its staff numbers by 10 percent in 2018 to deal with the extra work associated with MiFID II. The **Belgian** regulator is also increasing staff numbers.

European regulators are determined to implement post-crisis rules and to introduce new ones to encourage a "capital markets union" (CMU) within the EU. However, the pace and scale of reform in Europe has led regulators to pause for reflection. Most say publicly or privately that further radical reform over the next couple of years is unlikely. This is different from actually rolling back regulation, of course.

Towards rationalization of regulation

Every piece of European post-financial crisis legislation has a review clause.

Many of those reviews are scheduled to take place over the next three years.

European politicians, in particular, are interested in whether the reforms of the past few years offer "value for money". In November 2017, MEPs[10] urged the European Commission to harmonize rules governing funds and other financial products, arguing that the "silo-based patchwork" of directives is not compatible with CMU.

In a report, the European Parliament included demands for the Commission to bring together regulatory directives, such as MiFID II, the AIFMD[11] and the Insurance Distribution Directive. MEPs asked for "omnibus legislation" in order to move away from the silo-based patchwork of consumer protection rules for investment funds, insurance companies and banks.

Karel Lannoo, chief executive of the Centre for European Policies Studies, said the parliament's proposal is rational, noting that regulations have become "far too complex for most consumers to follow, […] let alone for regulators to implement". However, he doubted whether harmonization is possible, arguing that attempts to merge regulation could lead to even more complexity.

The Commission responded in December 2017, saying it would assess the cost of supervisory reporting requirements in an exercise that could lead to a reduction in red tape for fund managers.

As part of its so-called fitness check of supervisory reporting requirements, the Commission sought input from asset managers into the costs of complying with EU regulatory reporting regimes, as well as the consistency and effectiveness of the requirements.

[8] International Organization of Securities Commissions
[9] Markets in Financial Instruments Directive, revised
[10] Member of the European Parliament
[11] Alternative Investment Fund Managers Directive

The Commission asked asset managers to provide examples of "inconsistent, redundant or duplicative supervisory reporting requirements", such as where firms have to report the same information under different frameworks and/or to different supervisory authorities.

The Commission also examined whether information technology tools "could help reduce the compliance cost and whether there are any impediments to implementing and using such technology and standards".

The review of AIFMD, for example, was an early initiative. The **UK**'s Investment Association said reporting requirements under AIFMD have "caused managers significant difficulties". And **Luxembourg** fund association ALFI[12] said that preparing reports under AIFMD has led to "very significant costs for the industry".

The Commission also indicated that it will take a fresh look at UCITS[13] rules as part of the AIFMD review.

KPMG asked to study AIFMD effectiveness

KPMG Law Germany, in conjunction with other KPMG member firms, has been commissioned by the European Commission to undertake a major piece of research into how the AIFMD has been implemented and is working in practice. Has it achieved its objectives? Has it done so effectively, efficiently, relevantly and coherently, and has it provided added-value for the EU?

Meanwhile, the consultation on the Commission's fitness check of supervisory reporting requirements closed at the end of February 2018. In addition to the consultation, the Commission set up a stakeholder roundtable group to help it assess the costs of compliance with supervisory reporting requirements, and said it would commission a study to look in depth at the cost of compliance of supervisory reporting requirements.

EU regulation – review timeline

22 July 2017

EC** to start a review on the application and the scope of **AIFMD** (Art. 69) – delayed *

EC to review **EuVECA**** (Arts. 26 & 27) & **EuSEF**** (Arts. 27 & 28) Regulations and to start a review on their interaction with other rules on funds and fund managers (in particular AIFMD)

13 October 2017

EC to submit a report on progress in international efforts to mitigate SFT related risks, and any appropriate proposals (Art. 29 **SFTR****)

18 September 2017

No later than this date, EC shall conduct a review of the functioning of **UCITS IV** (Art. 85 UCITS V)

1 January 2018

EC to prepare a report on energy prices and markets (**MiFID II** Art. 90)

4 July 2018

EC to report on the functioning of **MAD II**** and any need to amend it (Art. 12)

3 September 2018

EC to present a report on CCP data (**MiFID II** Art. 90)

31 December 2018

EC deadline for review of the **PRIIPs Regulation** (including the future of the **UCITS KIID**) and a market survey of online calculator tools (Art. 33)

2017 | **2018**

CRD IV: EC shall conduct periodic reviews of the implementation of CRD IV to ensure it does not discriminate between institutions based on their legal structure or ownership model (Art. 161)

Benchmarks Regulation: every five years after 1 January 2019, EC to review the evolution of international benchmark principles, and of legal frameworks an supervisory practices in third countries, regarding the provision of benchmarks and should amend this Regulation if necessary

* The EC has decided to commission a lengthy study. It will review the results and may not consult until 2019. 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.

[12] Association of the Luxembourg Fund Industry
[13] Undertaking for Collective Investment in Transferable Securities
[14] Monetary Authority of Singapore

> Every piece of European post-financial crisis legislation has a review clause.

It will be interesting to see whether and how the deregulatory agenda in the US impacts policy makers' views on the extent to which EU legislation should be rationalized.

Will EU competitiveness become a key theme in debates?

Singapore is revising some rules. The new flexibility for investors to opt in to or out of the "accredited" class is expected to be in force soon. And in September 2017, MAS[14] proposed to streamline the representative notification framework for those representatives that serve only non-retail customers, but emphasized the duty of the fund manager to ensure their representatives are fit and proper and meet requisite standards.

From April 2018, MAS has exempted asset managers with an annual aggregate gross notional amount of less than SGD 5 billion in specified derivatives contracts, which are entered into with counterparties who are accredited or institutional investors, from the derivative reporting obligation.

Also, MAS introduced a simplified regime for venture capital fund managers (VCFMs). The authorization process has been shortened and capital, business conduct and independent audit requirements have been removed. VCFM shareholders, directors and key personnel must meet fit and proper requirements, though, and the funds must be at least 80 percent invested in unlisted, young enterprises (of less than 10 years), must not be redeemable at the investor's discretion and must be offered only to accredited or institutional end-investors.

3 March 2019
Before this date, EC to review and report on **MiFID II** (Art. 90)

9 June 2019
EC to have started a review of the **ELTIF** Regulation** (Art. 37)

3 July 2019
EC to submit a report on MAR** (Art. 38)

1 January 2020
EC to review the **Benchmarks Regulation** (Art. 54) – see also below

2020
EC to submit a report on the effectiveness, efficiency and proportionality of the obligations in **SFTR** (Art. 29)

3 September 2020
EC to present a report on CCP data policies (**MiFID II** Art. 90)

2020 / 2021
EC to submit a report on the application of supervisory fees (Art. 29 **SFTR**)

April 2022
EC to review the prudential and economic aspects of the **MMF Regulation** (Art. 46)

13 January 2023
EC to review **IORPD II **** and report on its implementation and effectiveness (Art. 62)

2019 | **2020 onwards**

Footnotes – definitions:
European Commission
Securities Finance Transactions Regulation
European Venture Capital Fund
European Social Entrepreneurship Fund
Market Abuse Directive, revised
Market Abuse Regulation
European Long-Term Investment Fund
Institutions for Occupational Retirement Provision Directive, revised.
Capital Requirements Directive, revised

A word on supervision

Interestingly, existing regulation is being supervised more tightly than ever in the US[15]. In its 2018 enforcement priorities, the SEC has signaled a growing number of examinations and ever more visits to investment firms.

It is planning to change its "broken windows" approach, which holds that minor violations are signals of larger infringement of rules, to a risk-based approach. This new approach is believed to be more effective, but involves considerable work for the regulator since it entails greater collaboration with the industry and ongoing dialogue.

The weight of SEC enforcement work is growing so fast the SEC has requested increased funding. It is also proposing to make greater use of technology and there is talk of the possible use of third parties to undertake certain tasks.

Japan's regulator, the JFSA[16], is also adopting a new approach to supervision. Its mission is to contribute to the national welfare by securing sustainable growth of national economy and wealth. In order to accomplish its mission, it is reforming its culture, governance, organization and supervisory approaches. It is also pursuing more efficient, speedy and transparent registration processes.

In March 2018, the **Australian** Government announced the creation of a new deputy commissioner role at the Australian Securities and Investments Commission (ASIC), to strengthen the regulator and enable it to manage the increased breadth of new powers.

The **French** regulator, the AMF[17], issued a five-year strategic document setting out changes to the way it will operate, in order to assist businesses, by being both proactive and responsive, and to prevent risks. It intends to expand its expertise, and to adapt its working methods and intervention tools, for example by embracing digital developments. It will introduce thematic reviews – called SPOT controls – in order to benchmark players and to identify and promote best practices.

In Europe, the Commission has proposed handing Europe's main securities regulator, ESMA[18], sweeping new supervisory powers. These include a power to review fund houses' delegation arrangements and intervene if it has concerns about lack of oversight or substance.

It is also proposed that ESMA will be the single supervisory body for European venture capital, social entrepreneurship and long-term investment funds. And it is to be given explicit product intervention powers under the UCITS Directive and AIFMD, mirroring the powers introduced under the Markets in Financial Instruments Regulation (MiFIR).

New supervisory approach of the JFSA

From the Form to **the Substance**		
Focusing on whether minimum standards are being formally met	»	Focusing on whether high-quality financial services (best practices) are being provided
From the Past to **the Future**		
Focusing on checking soundness at times in the past	»	Focusing on whether sustainability and soundness are ensured in the long run
From Element by element analysis to **Holistic analysis**		
Focusing on responding to specific individual problems	»	Focusing on whether responses to truly important problems are successful from the whole business point of view

[15] https://www.sec.gov/news/press-release/2018-12
[16] Japanese Financial Services Agency
[17] Autorité des Marchés Financiers
[18] European Securities and Markets Authority

The proposals have received mixed reactions.

According to **France**'s AMF, bolstering ESMA's powers is imperative to increasing the effectiveness of European supervision, in particular in the setting of third country rules and in building a uniform application of common rules across Europe. The **UK**'s impending departure from the EU – Brexit – has highlighted that the existing equivalence regimes "must be reviewed", the AMF noted.

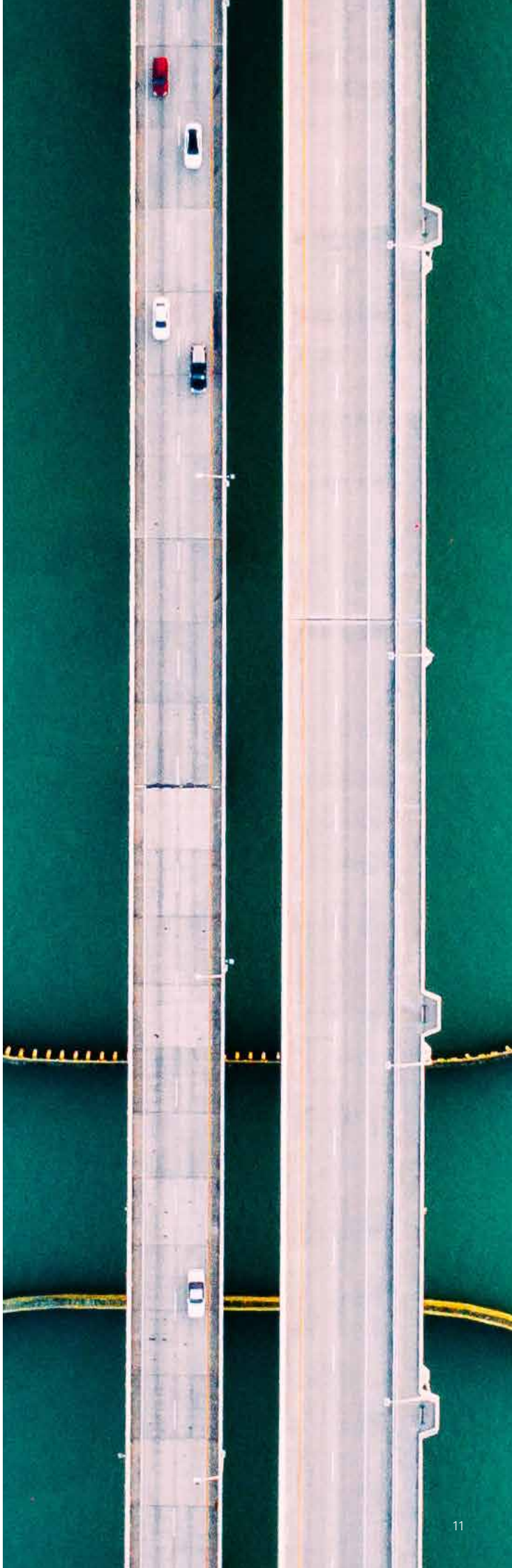
On the other hand, the national regulators in the other major asset management and fund centers, including **Germany**, have opposed the proposals, especially in relation to delegation (discussed in more detail in Chapter 5).

In November 2017, Pierre Gramegna, **Luxembourg's** finance minister, said Luxembourg had asked the European Council's legal service to look into the legal basis of the proposal. It also asked whether the proposals comply with the Meroni doctrine. Meroni was a landmark 1958 case that limits the powers that can be delegated to EU agencies.

Sweden formally complained that the proposals violate principles of national authority. In January 2018, the Swedish government submitted an official objection to the proposals, warning that they run counter to "subsidiarity", which states that EU action can be taken only when it is more effective than action at national or regional level.

The move was a further indication that the Commission's desire to empower ESMA faces considerable opposition as the legislation moves through the European Parliament and Council.

In **Canada**, meanwhile, progress is being made towards a national securities regulator to unify a patchwork of provincial regulation of capital markets. Legislation is expected in June 2018, with participation by the federal government and six of the provinces.



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