



Parting of the ways?

**Evolving Asset Management
Regulation report**

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Executive summary

In last year's report¹ we conjectured that the new political context within Europe and in the US, and developments in Asia and elsewhere, were likely to have a significant influence on regulatory policy and rule-making, during 2017 and beyond. Our insight has been proven correct.

After the financial crisis, regulators around the globe agreed common aims to enhance the integrity of markets and to reduce risks for governments and consumers. There was consensus on the overall regulatory agenda and priorities, leading to a convergence of worldwide regulatory standards. **That consensus now appears to be breaking down:** there is a parting of the ways.

The US administration believes the raft of post-crisis regulation has encumbered its asset management industry. There is a desire to deregulate and take a path that forks from that of other countries, which are forging ahead with the implementation of new rules.

Within Europe, each piece of post-crisis regulation has a review clause, but each of these reviews has a different due-by date. There are some calls to review rules in the round and consider rationalization, as has happened in the US. 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 competitiveness become a key theme in regulatory debates?

As regards supervisory activities, though, there is a common global theme – increased scrutiny of the asset management sector. Regulators are evolving their supervisory approach, seeking increased resources and harnessing technology.

A parting of the ways is especially clear in the **ongoing debate about systemic risks** inherent in asset management activities and investment funds. Outside the US, the application of a banking policy mind-set to open-ended funds is creating tension within the global industry. The need for debate on leverage and on liquidity risk management is understood, but the narrow focus on widely-held open-ended funds is questioned. The growth in exchange-traded funds has brought them under the spotlight, but arguments, counter-arguments and mixed messages make it difficult to call the direction of the debate.

¹ <https://home.kpmg.com/uk/en/home/insights/2017/06/evolving-investment-management-regulation-fs.html>

Meanwhile, **regulators continue to focus on governance, culture and conduct**. Within Europe, MiFID II² has thrown up a number of implementation issues and questions about fragmentation of the single market. Elsewhere, a number of emerging themes chime with European developments, such as increasing focus on named individuals and clarity of roles, and on risk and compliance functions. Product governance and disclosures remain firmly in regulators’ sights, as do fund distributors in general and financial advisers in particular.

The **protection of client data has emerged as a major priority**, with big questions for asset managers about what data they hold and whether they may need to restrict cross border flows.

Simple and meaningful cost disclosures for funds remain firmly on the regulatory agenda but are elusive. And an increasing number of regulators are also scrutinizing the level of costs and charges. **Are investors being put front and centre?**

A number of countries are establishing new domestic fund structures to compete with foreign options. The word **competitiveness is beginning to re-enter regulatory language**. Despite best intentions, though, cross-border distribution of investment funds is far from frictionless.

Use of the Asian fund passports remains low and bilateral passporting arrangements seem more promising in the short term. The European Commission has made it a priority for 2018 to remove barriers to creating a more competitive pan-EU investment landscape, including for personal pensions. However, there are questions about whether its proposals will result in more red tape, not less.

“Brexit” will impact cross border flows between the UK and the rest of the EU, in both directions. Also, the EU regulatory approach to the provision of portfolio management from one jurisdiction to another – or “delegation” – looks set to become more demanding.

It seems that asset managers will need to **navigate a complex distribution landscape** for some years to come.

Regulation is also entering new areas of the asset management business. It is evolving to facilitate the development of “fintech” and to be fit-for-purpose in the digital age, for example. Regulators recognize the benefits of new technologies and are seeking to accommodate them, but they are also concerned about existing risks that could be heightened by the new forms of services. Cyber security, robo-advice, crowdfunding and cryptocurrencies are all under consideration.

Sustainable investing was until recently considered a matter only for asset managers and investor preferences.

This subject, too, has now entered the regulatory mainstream. Initiatives relating to environmental, social and governance (ESG) factors and socially-responsible investing (SRI) have received regulatory support in several countries.

As institutional investors increasingly ask more questions about ESG and SRI – in part prompted by their own beneficiaries’ demands, in part by regulatory suasion – the long-standing debate about **whether consideration of ESG factors or SRI fits with fiduciary responsibility** is evolving. Also, some regulators are beginning to ask questions about diversity in the work force.

While navigating an increasingly complex regulatory landscape, asset managers will need to keep their eye on the reviews of post-crisis regulation and further regulatory proposals. It seems that the industry will need to operate within and manage uncertainty, for some time to come.

Key issues for CEOs

- **Factor into your business plans both the fragmenting and complex regulatory landscape and increasing supervisory scrutiny**
- **Watch carefully the evolving debate on systemic risks as more sectors of the industry are brought into focus**
- **Ensure your governance model, culture and conduct conform with new regulatory expressions of good practice, including product governance, disclosures and protection of client data**
- **Review your decision-making and monitoring process around fee structures and fee rates. Can you evidence that the investor is being put front and centre in those decisions?**
- **Consider how best to navigate an increasingly complex distribution landscape**
- **Embrace technological developments but ensure full consideration of the attendant risks**
- **Consider ESG factors and SRI, which are becoming a regulatory must for asset managers and institutional investors**

² Markets In Financial Instruments Directive, revised

Chapter 1

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 report¹, 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 SEC² money market fund rule reforms, enhanced fund reporting, liquidity rulemaking, the Department of Labor (DoL) fiduciary rule, new SRO³ rules, and requirements related to Dodd-Frank⁴ 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 rule⁵, 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 SEC⁶ 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-regulatory 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.



An aerial photograph of a winding asphalt road that curves through a dense, green forest. Several cars are visible on the road, including a red car, a white car, and a blue car. The road has white dashed lines and a yellow guardrail on one side.

The US view on international engagement

In some cases, the **US** Treasury observes, the FSB⁷ 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 IOSCO⁸ 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 II⁹ 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, MEPs¹⁰ 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 AIFMD¹¹ 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 ALFI¹² 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 UCITS¹³ 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	13 October 2017	18 September 2017	1 January 2018	4 July 2018	3 September 2018	31 December 2018
EC** to start a review on the application and the scope of AIFMD (Art. 69) – delayed *	EC to submit a report on progress in international efforts to mitigate SFT related risks, and any appropriate proposals (Art. 29 SFTR**)	No later than this date, EC shall conduct a review of the functioning of UCITS IV (Art. 85 UCITS V)	EC to prepare a report on energy prices and markets (MiFID II Art. 90)	EC to report on the functioning of MAD II** and any need to amend it (Art. 12)	EC to present a report on CCP data (MiFID II Art. 90)	EC deadline for review of the PRIPs 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 a 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, MAS¹⁴ 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	9 June 2019	3 July 2019	1 January 2020	2020	3 September 2020	2020 / 2021	April 2022	13 January 2023
Before this date, EC to review and report on MiFID II (Art. 90)	EC to have started a review of the EL-TIF** Regulation (Art. 37)	EC to submit a report on MAR** (Art. 38)	EC to review the Benchmarks Regulation (Art. 54) – see also below	EC to submit a report on the effectiveness, efficiency and proportionality of the obligations in SFTR (Art. 29)	EC to present a report on CCP data policies (MiFID II Art. 90)	EC to submit a report on the application of supervisory fees (Art. 29 SFTR)	EC to review the prudential and economic aspects of the MMF Regulation (Art. 46)	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 US¹⁵. 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 JFSA¹⁶, 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 AMF¹⁷, 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, ESMA¹⁸, 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.

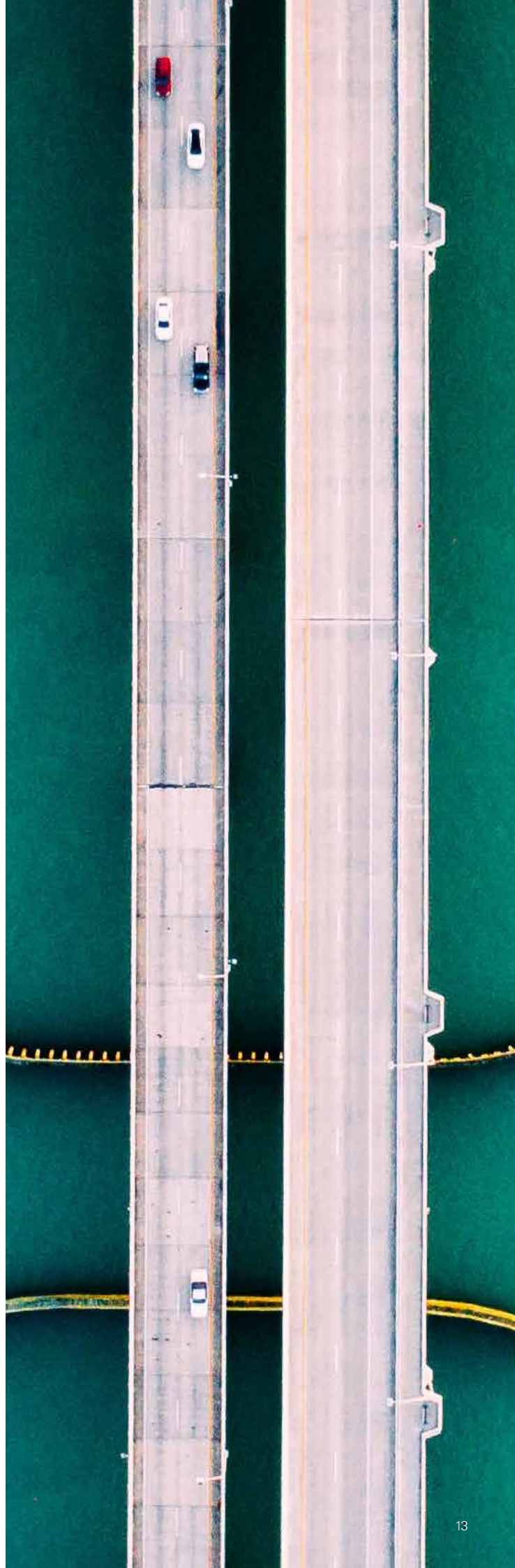
On the other hand, the national regulators in the other major asset management and fund centers, including **Germany**, have opposed the proposals, especially in relation to delegation (discussed in more detail in Chapter 5).

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.



Chapter 2

Systemic risk – the big divide

Nowhere is the difference in approach of the **US** and the rest of the world clearer than in the systemic risk debate. Where once, Dodd-Frank¹ and MiFID II/MiFIR² progressed in lockstep, today views on the systemic risk that investment funds present could hardly be more divergent.

Outside the US, the ongoing application of a banking policy mindset to open-ended funds is creating considerable tension within the global industry.

The FSB³ issued 14 policy recommendations to address what it describes as structural vulnerabilities from asset management. It is revisiting assessment methodologies for identifying non-bank, non-insurance globally systemically important financial institutions (NBNI G-SIFIs) – a major bone of contention for the industry.

Meanwhile, IOSCO⁴ has issued revised guidelines on liquidity risk management in funds and is working towards globally-accepted measures of leverage.

1 US Dodd-Frank Wall Street Reform and Consumer Protection Act

2 Markets in Financial Instruments Directive, revised and Markets in Financial Instruments Regulation

3 Financial Stability Board

4 International Organization of Securities Commissions

5 European Securities and Markets Authority

6 Undertakings for Collective Investment in Transferable Securities

7 Alternative Investment Fund Managers Directive

Are asset managers and funds systemically risky?

The FSB acknowledges that open-ended funds have been generally resilient and have not created financial stability concerns in recent periods of stress and heightened volatility, with the exception of some money market funds. It is concerned, though, that open-ended funds investing in less actively traded assets, but which offer daily redemption for investors, could amplify downward repricing of these assets and market illiquidity if investors try to redeem at the same time.

Of the FSB’s 14 policy recommendations, nine relate to liquidity management, and the others to leverage, securities lending and operational risk management. Within **Europe**, many of these recommendations are already in place in EU or national requirements, but a few – such as industry-wide stress testing – are new.

The FSB’s policy recommendations require regulators to collect and share more information from fund managers and to review disclosures to investors.

“open-ended funds have been generally resilient and have not created financial stability concerns”

The FSB also highlighted that although non-bank financial entities that are dependent on short-term funding to support lending activities have declined since the crisis to eight percent of shadow banking assets, these entities tend to have relatively high leverage. To address the lack of a consistent measure of leverage, the FSB suggested that IOSCO develop globally-agreed risk based measures and collect national and regional leverage data.

Meanwhile, in February 2018, IOSCO published its final report on Recommendations for Liquidity Risk Management for Collective Investment Schemes.

These recommendations are accompanied by a “good practices” document, which provides practical examples of measures to address liquidity risk management, for the use of supervisors, fund managers and investors. Hot on its heels, the European Systemic Risk Board (ESRB) issued five recommendations addressed to the European Commission and to ESMA relating to liquidity risk management and leverage.

The final IOSCO recommendations replace the existing principles of March 2013 and include new recommendations on contingency planning. They also consider additional liquidity management tools, the profile of the investor base and the fair treatment of investors.

Of particular note is that the recommendations do not reflect the FSB proposals relating to system-wide stress-tests or the prescriptive use of pre-selected liquidity “buckets”, depending on the underlying assets’ contingent liquidity state.

In this sense, the recommendations are in synch with the US Treasury report.

The **Singapore** regulator is one of a number of national regulators to have issued consultations on new guidelines for liquidity risk management that reflect the IOSCO recommendations.

The ESRB’s five recommendations were more prescriptive, however. It believes that the increasing size of the investment fund sector, coupled with perceived susceptibility to changes in market dynamics and structure, warrants legislative action. It is specifically concerned about mismatches between the liquidity of underlying assets and a fund’s redemption policy.

It wishes ESMA⁵ to develop guidance by June 2019 on the stress testing of liquidity risk in individual funds and on assessing the extent to which leverage in funds contributes to the build-up of systemic risk. In particular, ESMA should provide guidance on the design, calibration and implementation of macro-prudential leverage limits.

The ESRB tasks the European Commission to have implemented changes to the UCITS⁶ Directive and AIFMD⁷ by December 2020.

Germany is on the hawkish side of the argument. Its central bank warned in December 2017 that the growing interconnectedness of German investment funds are contributing to systemic risks. The Bundesbank argued that the portfolios of many funds overlap significantly and expressed particular concern over multi-manager funds, which invest in other funds. As of June 2017, assets that funds hold in other funds amounted to EUR 406 billion, or 23.5 percent of overall assets held in funds in Germany.

The Bundesbank report echoes recommendations made by the FSB, which proposed the introduction of redemption gates, swing pricing and side pockets to control liquidity risks. The report also chimes with ESMA’s stated aim to subject asset managers to tougher scrutiny on whether they pose a systemic risk.

Switzerland has not taken such a strong line as Germany, but the regulator is implementing reporting requirements for derivative transactions. From 1 January 2019 asset managers are obliged to clear certain over-the-counter derivatives through a central counterparty.

US takes a different line

The **US** Treasury is at pains to disagree with nearly all of the above. The Treasury noted in its late 2017 report⁸ that the performance of the asset management industry during periods of financial stress demonstrates that the types of industry-wide “runs” that occur in the banking industry during a systemic crisis have not materialized in the asset management industry, outside money market mutual funds.

Since the turn of the century, it said, aggregate net flows — either total net redemptions or subscriptions — into equity and debt funds have rarely exceeded more than 1 percent and 2 percent of total assets under management on a monthly basis, respectively. This trend even continued through the financial crisis, when mass redemptions would have been most likely.

The Treasury believes the asset management industry should not have been targeted in the wake of the financial crisis, through the passage of Dodd-Frank, the actions of the FSB and other international bodies. A framework emerged that assessed systemic risk posed by specific financial entities. Asset management firms have been evaluated for systemic risk and subjected to some enhanced regulatory standards. Yet they have legal, structural and operational characteristics that make them different to banks, the Treasury noted.

“Asset management firms....have legal, structural and operational characteristics that make them different to banks”

The Treasury’s position is that “entity-based evaluations of systemic risk are generally not the best approach” for mitigating risks arising in the asset management and insurance industries. The Treasury, however, supports shifting to an activities-based framework, which would identify certain business activities as having higher systemic risk.

Funds are not “shadow banks”

The US Treasury is not enthusiastic about the FSB categorizing mutual funds as “shadow banks”. It noted that FSB reports often use the term “shadow banking” to describe credit intermediation involving activities outside the regular banking system. The Treasury said it preferred the term “market-based finance”. Applying the term shadow banking to registered investment companies is particularly inappropriate, it said, as the word “shadow” could be interpreted as implying insufficient regulatory oversight or disclosure.

The Treasury outright rejects the need for stress testing of asset management firms. It recognizes the possibility of liquidity risk that may arise during mutual fund redemptions, but believes a strong liquidity risk management framework is a more effective approach.

Prudential regulation of asset management is unlikely to be the most effective regulatory approach for mitigating risks, it said. Asset managers and investment funds, in contrast to banks, are not highly leveraged and do not engage in maturity and liquidity transformation to the same degree. Any decline in the value of a fund’s assets results in a corresponding reduction in the investor’s investment, whereas a bank’s obligation to its depositors and creditors remains the same, even if the bank suffers losses on its asset exposures.

While the Treasury endorsed the principle of appropriate risk management in the asset management industry, it does not support prudential stress testing of investment advisers and investment companies, as required by Dodd-Frank. The Treasury said it supported legislative action to amend Dodd-Frank to eliminate the stress testing requirement.

While the Treasury said it strongly supported continued US participation in international standard setting bodies, such as the FSB and IOSCO, it said this would be solely to promote US interests. Moreover, the Treasury believes the US should play a bigger role in these bodies, particularly with respect to financial market supervision and asset management “where our firms and markets are the largest in the world”. It demanded that US agencies that have seats on the FSB, IOSCO, or other international bodies, should “more effectively coordinate their representation on behalf of the United States”.

⁸ <https://www.treasury.gov/press-center/news/Pages/A-Financial-System-That-Creates-Economic-Opportunities—Asset-Management-and-Insurance.aspx>

In addition, the Treasury recommends improvements to the FSB's and other bodies' processes to better promote transparency, accountability and appropriate representation. It particularly encouraged the FSB to expand its practice of posting summaries of the comments raised in consultation processes and changes made to address such comments. It recommends that US representatives on the FSB and IOSCO boards review processes to ensure that they use a collaborative process that includes economic analysis and subject-matter expertise.

It finally recommended that the US members of the FSB should work to revise the G-SIFI framework so it takes into account the differentiated ways that sectors are structured and manage risks.

The Treasury also wants the SEC to take over some of the functions of the FSOC⁹, which was created by President Obama after the financial crisis to deal with systemic risks. While the FSOC should maintain primary responsibility for identifying, evaluating and addressing systemic risks in the US financial system, the Treasury believes it should "look to the SEC to address systemic risks through regulation within and across the asset management industry in the United States".

Are ETFs systemically risky?

IOSCO launched its second examination of the exchange-traded fund (ETF) industry, which was published in early 2018. IOSCO was looking at recommendations to strengthen the oversight of ETFs in order to protect investors, considering whether market distortions might be caused by the rapid growth of ETFs. IOSCO had said, in its first exam, in 2017, that it would review the global ETF industry, particularly the rise of leveraged, inverse and synthetic ETFs.

Paul Andrews, Secretary General of IOSCO, said questions needed to be asked about whether ETFs could cope with pricing or liquidity shocks as central banks withdraw from emergency support measures and tighten monetary policy. IOSCO also assessed whether ETFs were creating changes in market structure that could result in the misallocation of capital. It was concerned that large institutional investors could manipulate the prices of ETFs to create profitable trading opportunities.



⁹ Financial Stability Oversight Council



In the end, IOSCO decided not to issue specific recommendations for ETFs, but noted that it was continuing to monitor liquidity stresses in the global ETF market, with a focus on authorized participants and market makers. The IOSCO 2013 ETF Principles may be reviewed at a later date, it said.

In September 2017, **Germany's** BaFin¹⁰ became the latest national regulator to warn that ETFs could pose potential risks to financial market stability. It said ETFs are not yet a threat to market stability but could become a danger. It warned that sudden massive sell-offs by ETFs "could cause a problem," particularly in products that invest in less-liquid assets. The regulator said it may take regulatory action in future.

The Central Bank of Ireland (CBI), which supervises Europe's largest ETF domicile, launched an information-gathering exercise on ETFs during 2017. Its Discussion Paper highlighted the low proportion of active ETFs in Europe and asked industry participants for feedback on whether "alternative approaches to full portfolio transparency should be permitted for active ETFs".

In November 2017, the CBI held a conference in order to inform regulatory policy development. The key topics deliberated upon were the suitability of the current regulatory regime under UCITS and MiFID II for ETFs, risks potentially associated with Authorised Participants, and investor protection.

The regulator is now considering whether to relax portfolio disclosure rules for ETFs to facilitate a broader range of investment strategies, by changing the substance or timing of disclosure. It is expected to release proposals in late 2018.

In **France**, the AMF¹¹ completed an in-depth investigation into ETFs after it raised concerns about liquidity and the industry's rapid growth. On 24 March 2018, the regulator proposed three amendments to its ETF policy: to widen the options for funds to repay "in kind"; to implement an action plan in the event of significant valuation or liquidity problems; and to draw up a continuity plan in the event of a default or counterparty issue. The deadline for responses was 24 May 2018.

With the exception of ESMA guidelines published in 2012, there are not yet specific **EU** rules for ETFs. The discussion in various EU countries could pave the way for ESMA to outline a more uniform approach to transparency, including a mechanism to limit the requirement for active ETFs to disclose portfolios on a daily basis.

¹⁰ Bundesanstalt für Finanzdienstleistungsaufsicht

¹¹ Autorité des Marchés Financiers

¹² Financial Conduct Authority

¹³ Securities and Futures Commission

¹⁴ Member of European Parliament

Ireland's CBI in December 2017 suggested a new regulatory framework for ETFs to enhance investor protection. The CBI said the current regulatory framework may not be able to deal with all the complexities of ETFs. It recommended there could be "an ETF chapter" in the forthcoming review of UCITS or a specific pan-European regime for ETFs.

On the other hand, Megan Butler, executive director of supervision for investment, wholesale and specialists at the **UK's** FCA¹², said regulators "need to be careful" that they understand the dynamics between ETFs and markets before coming "to the conclusion that there is a need for extensive new regulatory interventions" for ETFs.

Counter-arguments and mixed messages

Fund managers have cautioned against imposing a specific regime for ETFs in their responses to IOSCO's consultation. This, they say, could involve increased compliance costs and a narrowing of the range of eligible investments. They argue that ETFs do not pose any greater liquidity risk than mutual funds.

These arguments are espoused by the **US** Treasury, which recommended that the SEC move forward with a "plain vanilla" ETF rule that allows entrants to access the market without the cost and delay of obtaining exemptive relief orders. To this end, the SEC should either re-propose or propose a new rule on ETFs for public comment.

Adopting a plain vanilla ETF rule would not only reduce cost and delay for new entrants, said the Treasury, it would also enable ETF sponsors to avoid the potential for costly updates to existing exemptive relief orders when introducing new products, and help reduce uneven treatment between ETFs. Likewise, a plain vanilla ETF rule would enable the SEC staff to focus efforts on more novel and more difficult ETF exemptive relief applications.

ESMA and other policy-makers have expressed concern about the growth in the ETF market, which comprises mainly passively-managed funds. At the same time, the **European** Commission and some national regulators have suggested that retail investors are better off investing in passive funds.

Hong Kong, too, has entered the debate. The SFC¹³ issued in January 2018 a research paper on the local ETF market. It considered the risk of ETF prices decoupling from net asset values (NAVs), the reliance on authorized participants, the liquidity of underlying assets, actively-managed ETFs and the growth of passive investing in general. It concluded that at this time the various regulatory initiatives already in train for funds are sufficient to address these issues. It maintains a watching brief.

“ESMA and other policy-makers have expressed concern about the growth in the ETF market.”

Further uncertainty for European Money Market Funds

After three years of heated debate, the Money Market Funds Regulation (MMFR) was finally agreed by both the **European** Parliament and the Council at the end of 2016 and comes into force on 21 July 2018.

But a new, and very significant, issue has now emerged. A letter from the European Commission to ESMA in early 2018 described the practice of share cancellation as incompatible with the MMFR. This has caused further uncertainty for money market funds and their investors.

The MMFR is silent on the practice of share cancellation as a mechanism to preserve a fund's NAV, which is commonly used when interest rates are negative. However, the European Commission's recent letter to ESMA says that, according to its legal analysis of the regulation, the use of the reverse distribution mechanism, which is often referred to as "share cancellation" or "share destruction", is not compatible with the MMFR.

The debate intensified further with a letter from the MEP¹⁴ MMFR negotiating team to Commissioner Dombrovskis. An explicit position was not taken on the practice of share cancellation as part of the negotiations, it said.

At the time of writing, the MEPs and the industry awaited the Commission's response and ESMA's reaction. If the Commission's opinion holds sway, it could sound the death knell for constant net asset value funds and cause major disruption for investors and managers.

Chapter 3

Outside the US, drive to implement rules is relentless

Regulators around the globe continue to focus on governance, culture and conduct.

Within **Europe**, MiFID II¹ is king, but has thrown up a number of implementation issues and questions about fragmentation of the single market.

Elsewhere, there is little standardization about how corporate governance is defined and implemented, with each jurisdiction focusing on areas of concern to local investors and politicians. There are a number of emerging themes, though, which chime with developments in Europe, such as increasing focus on named individuals and clarity of roles, and on risk and compliance functions.

Product governance and disclosures remain firmly in regulators' sights, as do fund distributors in general and financial advisers in particular. And the protection of client data has become a major priority.

¹ Markets in Financial Instruments Directive, revised

Governance now a global issue

In September 2017, the EBA and ESMA published joint guidelines for assessing the suitability of members of management bodies and key function holders. The aim was to harmonize and improve suitability assessments and to ensure sound governance arrangements in investment firms, in line with CRD IV² and MiFID II.

In **Hong Kong** in 2017, the SFC³ issued changes to the Fund Manager Code of Conduct (FMCC), including point-of-sale transparency, effective from 17 November 2018.

The driving force behind the changes to the FMCC is the perceived need for Hong Kong to comply with broader international initiatives, such as those of IOSCO.

“ thematic review of best execution found inadequacies or deficiencies ”

The SFC also issued on 30 January 2018 a circular reminding brokers and asset managers of their best execution obligations. Its thematic review of best execution found inadequacies or deficiencies in a number of firms in Hong Kong in relation to governance and supervision, staff responsibilities, controls and monitoring, best execution factors, and relations with affiliates, connected persons and third parties. It also identified good practices that go beyond the SFC's expected standards.

Expanded scope of Hong Kong code of conduct

The scope of the revised FMCC is considerably broader than that of the FMCC currently in force. The revised FMCC applies not only to licensed and registered persons whose businesses involve the management of collective investment schemes (whether authorized or not), but also to intermediaries that manage discretionary accounts. The FMCC revisions relate specifically to securities lending and repurchase agreements (repos), custody, liquidity risk management and disclosure of leverage. The revised FMCC will affect fund managers of offshore and onshore private funds.

Firms in **Singapore** are expected to be subject to enhanced best execution rules, following a consultation by MAS in November 2017.

“Best interest” has been a focus of the **Canadian** Securities Administrators (the CSA). In 2016, they explored an explicit best interest standard for dealers and advisers. Now, however, they have softened their approach and are considering changes to refine or eliminate some aspects of the original proposals.

In the **UAE**, culture and conduct have been looked at recently in more detail by the regulators, although no additional governance rules have yet been made as a direct result. One of the challenges faced in the UAE is that the vast majority of wealth and asset manager workers are ex-pats, which creates different cultural challenges than in many other jurisdictions. The DFSA⁵ has recently looked in particular at compensation and corporate governance.

The new FinSA/FinIA⁶ regulations in **Switzerland** introduce supervisory rules of conduct for asset managers and investment advisers. FinSA sets out duties relating to organization and governance, suitability and appropriateness when providing investment advice or portfolio management, information, documentation and accountability, as well as transparency and diligence for client orders. Such conduct rules already existed in Switzerland but had their legal basis only in civil law. FinSA will introduce the rules into supervisory law, which allows FINMA⁷ to enforce them.

The **Indian** regulator is proposing a different approach. In January 2018, it issued a consultation proposing amendments to the investment adviser regulation that would prohibit an entity from both advising clients on investments and selling investments to them. This approach is in response to concerns about conflicts of interest.

In **Australia**, governance rules have come thick and fast following a series of scandals at banks and their captive asset managers, which led to the Future of Financial Advice review a few years ago, the ramifications of which are ongoing.

Recent reports issued by ASIC⁸ include a deep dive into the quality of financial advice and the adequacy of the internal audit functions of managers. The recently-created Financial Adviser Standards and Ethics Authority has considerable powers, including setting qualifications and exams for practitioners.

² Capital Requirements Directive, revised

³ Securities and Futures Commission

⁴ Monetary Authority of Singapore

⁵ Dubai Financial Services Authority

⁶ Financial Services Act and Financial Institutions Act

⁷ Financial Market Supervisory Authority

⁸ Australian Securities and Investments Commission

The introduction of Professional Standard of Financial Advisers rules establishes an education and professional standards framework for the financial planning profession. New financial planners from 1 January 2019 will require a degree, need to undertake a year of professional work and have to pass an exam. All financial planners will be required to undertake continuing professional development (CPD), be subject to a code of ethics (from 1 January 2020) and pass an exam (by 1 January 2021).

Into the rush of reports and regulations in Australia, a Royal Commission was added in February 2018. The first hearings of the Royal Commission took place in March 2018 in Melbourne, and wealth managers and asset managers were in scope, but much of the testimony related to banks. Unusually, the Royal Commission also called for submissions by regulators – with both APRA⁹ and ASIC invited to describe their roles during various misconduct events.

In response to the testimony, in April 2018 the government announced reforms significantly to strengthen criminal and civil penalties for corporate misconduct, and further boosted powers such as banning powers of ASIC.

Then there is the proposed Banking Executive Accountability Regime (BEAR), designed to make senior executives in banks more accountable for the actions and outcomes of their organization. It impacts mainly large and bank-owned asset and wealth managers, obliging them to undertake more compliance obligations, defining of roles and responsibilities, and remuneration planning, than currently exists. BEAR comes into effect on 1 July 2018.

BEAR clearly borrows from the **UK’s** Senior Managers and Certification Regime (SMCR), under which UK asset managers with GBP 50 billion or more in assets under management – estimated to be around 100 firms – will fall within the so-called enhanced regime, meaning they have to have a senior manager responsible for every area, activity and management function.

In fact, UK asset managers will not have to comply with SMCR until mid-2019 at the earliest, the FCA¹⁰ announced in December 2017. It was originally slated to take effect in 2018. The industry awaits confirmation of the implementation date, but notes that compliance with the new “value for money” governance rules (see Chapter 4) is due by 30 September 2019.

The FCA said it will take action against the executive responsible in cases where there is a contravention of a relevant requirement by a firm, but adds that the burden of proof will be on the regulator to show that the senior

Japan’s seven principles

Japan has put in place seven “Principles for Customer-oriented business Conduct” for financial institutions, including asset managers:

1. Formulation and publication of policy on customer oriented asset management and intermediation
2. Pursuit of the best interest of customers
3. Appropriate management of conflicts of interests
4. Clarification of commission fees
5. Ease of understanding on important information
6. Provision of services suitable for customers
7. Appropriate motivation framework for employees

manager did not take reasonable steps. In addition, the FCA has proposed that the boards of fund management companies should include independent directors, to address the “under-reporting” of issues such as cyberattacks (see Chapter 6).

In 2017, the **French** AMF¹¹, in its annual report on corporate governance, executive compensation, internal control and risk management in listed companies, put forward recommendations for companies and called on the professional associations to amend their code. It also discussed the requirements introduced by the Sapin II Act, which goes beyond the requirements of the EU Shareholder Rights Directive II and requires two binding votes: one, *ex ante*, on the management’s remuneration policy (effective from 2017) and a second, *ex post*, on the actual amount of fixed and variable remunerations granted to management for a given year (effective in 2018 in relation to 2017 compensation).

In **Ireland**, senior executives at fund firms could face conduct rules modelled on the UK’s regime. The CBI¹² included within its response to the recent Law Reform Commission’s Paper on Regulatory Enforcement and Corporate Offences a suggestion that measures should be adopted to strengthen the accountability of senior personnel in regulated financial service institutions. It also suggested consideration of the introduction of a criminal offence for “egregious recklessness” by the chiefs of financial firms that fail.

Meanwhile, new rules and guidance seeking to ensure the effectiveness of fund management companies take full effect from July 2018. This new framework sets out the regulatory expectation in relation to delegate

⁹ Australian Prudential Regulatory Authority

¹⁰ Financial Conduct Authority

¹¹ Autorité des Marchés Financiers

¹² Central Bank of Ireland

oversight, organisational effectiveness, directors' time commitments, managerial functions, and various operational and procedural issues.

In **Luxembourg**, the CSSF¹³ is also focusing on the accountability of senior management and boards. It has taken a very active approach through detailed onsite inspections for all regulated entities. It has focused on the quality of the internal controls framework and the oversight and monitoring of delegates.

AML¹⁴ practices are key governance areas in **Switzerland** and the **Channel Islands**, too. In 2018, the Swiss regulator stated in several press releases that AML is a key priority. Over recent years, the regulator has issued on average more than ten enforcement rulings a year, imposing sanctions including the dissolution of a bank, a license withdrawal from a fiduciary company and the disgorgement of illegally-generated profits.

Already rated as some of the best performing jurisdictions in combatting money laundering and terrorist financing, the **Guernsey** and **Jersey** regulators' approach to financial crime is to maintain these standards. They are seeking to implement the updated Financial Action Task Force requirements, as well as the AMLD IV¹⁵ and recommendations from recent MONEYVAL inspections, in addition to codifying substance requirements.

The Central Bank of **Bahrain** (CBB) has enhanced its AML and counter-terrorist financing framework to include guidance for asset managers to take reasonable steps to verify the identity of beneficial owners for their legal entity clients. It also requires asset managers to implement and comply with United Nations Security Council resolutions.

In December 2017, the **Cayman Island** Monetary Authority (CIMA) published updated guidance notes on the practical interpretation and application of the AML Regulations that came into force in October 2017. In the light of comments from the industry that the notes were causing some ambiguity and uncertainty, CIMA issued in April 2018 a notice confirming that all funds must designate money laundering reporting officers, deputy money laundering reporting officers and AML compliance officers. Funds, which have to date relied on their administrators to comply with AML requirements, must demonstrate compliance by 30 September 2018.

Meanwhile in **Cyprus**, in line with wider requirements for stronger governance structures, the minimum number of directors for self-managed AIFs¹⁶ was increased, to a minimum of three to four directors (depending on the precise AIF structure).



¹³ Commission de Surveillance du Secteur Financier

¹⁴ Anti-money laundering

¹⁵ Anti-Money Laundering Directive IV

¹⁶ alternative investment fund

“ ESMA says the assessment of suitability is one of the most important requirements for investor protection in the MiFID framework ”

Cyprus has also mandated the appointment of separate legal compliance and internal audit functions, where justified by the size and complexity of the AIF.

And in **Singapore**, from 1 January 2019, appointed representatives under the Securities and Futures Act will have to fulfil nine hours of CPD, with a minimum of six hours on rules or ethics, based on accredited courses.

MiFID II spearheads investor protection

In the unlikely case you missed it, MiFID II came into force at the start of 2018. It is wide-ranging, covering areas such as transparency in the capital markets, trading venues, reporting to the regulator, company governance, disclosures to clients, product governance, inducements, conflicts of interest and advice.

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" (see last year's report for further details¹⁷). It also bans commissions paid to independent financial advisers and wealth managers, and requires information about third-party payments to be provided to clients.

The path to MiFID II has not been easy. Regulators and asset managers alike have struggled with implementation. ESMA¹⁸, for instance, was still consulting on draft guidelines on certain aspects of the MiFID II suitability requirements after the implementation deadline and does not expect to have released all the final MiFID II guidelines until later in 2018.

ESMA says the assessment of suitability is one of the most important requirements for investor protection in the MiFID framework. It applies to the provision of any type of investment advice (whether independent or not) and to portfolio management services. Firms have to provide suitable personal recommendations to their clients or make suitable investment decisions on behalf of clients.

Suitability has to be assessed against clients' knowledge and experience, financial situation and investment objectives. To achieve this, investment firms have to obtain the necessary information from clients.

¹⁷ <https://home.kpmg.com/xx/en/home/insights/2017/05/evolving-investment-management-regulation-fs.html>

¹⁸ European Securities and Markets Authority



It is reported that in response to the enhanced requirements, some continental European banks are reviewing whether they wish to continue to offer financial advice to mainstream retail clients.

MiFID II implementation issues

Unsurprisingly, the many data-related issues and extra-territorial questions thrown up by MiFID II – and its close cousin on product disclosures, the PRIIP KID¹⁹ – left some firms unable fully to implement all aspects of the rules by January 2018, causing a block to the distribution of some funds. In particular, fund managers were concerned they would have to issue predicted performance and cost figures that could be misleading.

A week after the implementation date, for example, many products sold in **Germany** still lacked data required under MiFID II. According to data from NFS Netfonds, target market data was missing on 5,239 share classes, while

5,479 share classes lacked the necessary information on costs and charges.

One German fund platform warned in January 2018 that it would no longer sell funds that lack target market data. FondsKonzept, which has over EUR 7.3 billion in assets under administration, said it would pull the products from its range. German fund data provider WM Datenservice said that only half the funds it covers provided the necessary data.

However, Allfunds, Europe's largest third-party fund platform, said it would not delist funds that had not yet provided the data.

BaFin²⁰, the German regulator, subsequently told asset managers that it would be flexible in its approach to the implementation of MiFID II. Felix Hufeld, president of BaFin, said: "We are not going to bite somebody's head off if they are genuinely trying to implement the new rules on time, but fail to do so because they are having problems with something like IT."

In **France**, the AMF said it will not subject asset managers to SPOT controls (see Chapter 1) over new regulations such as MiFID II or the PRIIP KID until 2019. In its key priorities for 2018, the AMF said it would assist market participants with the implementation of these and other new rules, such as the MMFR²¹, and carry out shorter inspections.

A major extra-territorial issue of MiFID II is that it is in conflict with the **US** regulation on research payments. US brokers are not allowed to receive separate research payments unless they register as investment advisers – a status that carries with it extra obligations and liabilities.

In October 2017, at the "eleventh hour" and after intense discussions between the European Commission and the US, the SEC²² published three no-action letters, offering ways for brokers and asset managers to deal with the MiFID II unbundling rules for payment for investment research.

"Staff's letters take a measured approach in an area where the EU has mandated a change in the scope of accepted practice, and accommodate that change without substantially altering the U.S. regulatory approach," SEC Chairman, Jay Clayton, said. "These steps should preserve investor access to research in the near term, during which the Commission can assess the need for any further action."

In tandem, the European Commission published guidance setting out how EU firms can receive brokerage and research services from institutions in non-EU jurisdictions under MiFID II.

MiFID II suitability obligations

The objectives of the suitability assessment remain unchanged from MiFID, but the obligations have been further strengthened and detailed by:

- reference to the fact that the use of electronic systems in making personal recommendations or decisions to trade shall not reduce the responsibility of firms
- the requirement for firms to provide clients with a statement on suitability (the 'suitability report') prior to the conclusion of the recommended transaction
- further details on conduct rules for firms providing a periodic assessment of suitability
- the requirement for firms performing a suitability assessment to assess, taking into account the costs and complexity, whether equivalent products can meet the client's profile
- the requirement for firms to analyze the costs and benefits of switching from one investment to another
- the strengthened requirement for firms to consider the client's risk tolerance and ability to bear losses
- the extension of suitability requirements to structured deposits.

¹⁹ Packaged Retail Investment and Insurance-based Product Key Information Document

²⁰ Bundesanstalt für Finanzdienstleistungsaufsicht

²¹ Money Market Funds Regulation

²² Securities and Exchanges Commission

Market structure implications of MiFID II

The full ramifications of MiFID II will emerge over time, but some implications are already becoming clear.

For instance, asset managers are likely to cut back on the external research providers they use. In **Germany**, the Deutsche Vereinigung für Finanzanalyse und Asset Management, for example, an association of investment professionals, said local fund houses may cut their number of research providers by half. The association predicted that the culling process will only really start in 2019, even though MiFID II came into effect in January 2018.

This cull is perhaps natural given the costs involved. Investment firms are expected to pay external research providers an average of USD 10 million (EUR 8.5 million) for every USD 10 billion in equity assets they manage, according to a study. The survey, conducted by the CFA Institute among 365 individuals from 330 asset managers and other investors, shows the median annual cost of external equity research to be about 10 basis points of assets under management. Much lower costs are expected for fixed income, alternative and quantitative research.

Meanwhile, the larger German asset managers said they would not pass on costs of external research to customers. Elsewhere in Europe, some firms are absorbing the cost themselves (and may seek to renegotiate management fees), while others are operating research payment accounts with a budget for research costs, agreed with and paid for by their clients.

In the **UK**, the FCA said in February 2018 it would investigate the prices asset managers are paying for research under MiFID II. Some brokers have applied large discounts to their research in order to keep larger asset managers as clients – which may be in breach of inducement rules and detrimental to smaller investment firms.

Another challenge for fund managers is that MiFID II rules are implemented in different ways by EU member states. The **Netherlands** and the **UK** continue to stand alone in imposing a wide-spread ban on all commission payments to any form of distributors to retail investors. Other member states have not followed suit.

Germany, for example, said it would allow lenders with large branch networks to continue receiving inducements. Under German government proposals, banks with extensive branch networks will be able to continue to receive retrocessions from investment firms. Berlin argued that in order to give savers across the country access to financial advice, inducements are acceptable.



The rules on inducements are not being interpreted consistently. In order to keep receiving inducements under MiFID II, non-independent distributors have to demonstrate that the payment enhances the service offered to the client. However, what regulators mean by "enhancing the quality" is uncertain. Differing interpretations could lead to further fragmentation of the European fund market over the next two years. This fragmentation between countries potentially means less cross-border fund distribution and makes it harder for smaller boutiques to compete.

In general, there is likely to be increased competition among fund providers if there is a reduction in the number of fund providers that intermediaries and distributors do business with. In particular, countries with more expensive fund models could come under pressure.

Fund distribution in **Italy**, for instance, may face disruption with the disclosure of "retrocessions." The Italian market is the most expensive in Europe, according to Morningstar's Global Fund Investor Experience Study, partly due to high retrocessions paid to distributors.

Banks and networks of tied agents – known as *consulenti finanziari* – control about 90 percent of fund distribution in Italy, according to consultancy Platforum. *Consulenti* are already adapting to deal with changes under MiFID II, including the need for non-independent intermediaries to demonstrate that they "enhance the quality of the relevant service to the client" to continue to receive inducements.

As elsewhere, the increasing pressure on costs may lead to greater ETF²³ appetite in Italy, with discretionary fund managers using passives as a more significant part of portfolios.

There are concerns in **Germany** that the new rules for the provision of investment advice are irritating retail clients. Talking through the required disclosures regarding costs, risks and target market is taking at least an extra 30 minutes, extending the session time for advice on a simple investment portfolio. Firms are hopeful that BaFin will conclude it has been interpreting the rules too strictly and that the guidelines may be relaxed in places.

On a positive note (for ETF providers, anyway), the visibility of increased trading volumes may attract more investor inflows into ETFs. Competition will increase between traditional exchanges and other trading venues such as multilateral trading facilities for ETF order flow. The improvements in fund cost disclosure requirements should help to speed the adoption of ETFs among financial advisers and retail investors.

MiFID II is having a potential market impact outside the EU, too. In the **US**, in the light of the new MiFID II rules on unbundling of research payments, institutional investors such as the New York City pension fund and the Colorado state pension plan have publicly expressed concerns the US brokers will continue to receive payments embedded in trading commissions. The Council of Institutional Investors, which represents 120 US asset owners, said its members would be disadvantaged if they are not able to pay for investment research directly while their European counterparts can. Given the current deregulatory climate in the US, it seems unlikely that their wishes will be granted in the near term.

There's more to investor protection than MiFID II...

MiFID II is far from the only investor protection game in town. Across most of the globe, local regulators are firmly focused on preventing mis-selling, misrepresentation and other scandals that could hurt consumers and create political and media storms.

In **Switzerland**, the handling of commissions and inducements has been clarified by the Swiss Federal Court. In a nutshell, asset managers are allowed to pay and receive inducements if they disclose them to their clients in good time and the clients agree. After the introduction of FinSA, the court ruling was transposed into supervisory law.

Also, FINMA is introducing a new client categorization regime, which, in echoes of MiFID II, demands that funds must clearly state whether they are targeting retail clients, professional clients or institutional clients. Certain retail clients can request to be treated as professional clients, and professional clients can request to be treated as retail clients.

FinSA comes into force in 2019 and also imposes requirements relating to suitability and appropriateness of advice, and the duty to provide key information documents and prospectuses.

In addition, under the new regulation, independent asset managers will be regulated for the first time in Switzerland. Up until now, they have been required to join an SRO²⁴ only for AML purposes, whereas asset managers of funds are subject to FINMA authorization and prudential supervision under the Collective Investment Schemes Act.

In **Canada**, the CSA in 2017 published a consultation paper on the discontinuation of embedded commissions and hosted a series of roundtables. The paper sought input on the potential effects on investors and market participants and on potential measures that could mitigate any negative impacts of a change.

²³ exchange-traded fund

²⁴ self-regulatory organization

The **Channel Islands**, on the other hand, have explicitly said there is no appetite to create an equivalent regime to MiFID II in Jersey or Guernsey due to the European-centric nature of the EU legislation and limited business in the Channel Islands that will be caught.

Germany announced in February 2018 that it would bring previously lightly-regulated independent financial advisers under the supervision of BaFin. Independent financial intermediaries in Germany, which have a so-called paragraph 34 license, were not regulated by BaFin, with their licenses awarded by regional authorities. As part of the agreement signed by the new German government, these advisers will be brought under the direct supervision of BaFin.

Product innovation risks

The proliferation of innovative and traditional fund strategies is also keeping some regulators awake at night. With the goalposts constantly moving, it is not easy for regulators to ensure that investors are protected against each and every danger to their future wealth.

In **Hong Kong**, the SFC launched a three-month consultation on proposed amendments to the unit trust code to address risks posed by financial innovation and fast-moving market developments. The local market, according to the SFC, has been “flooded by newcomers”. Key proposals include strengthening requirements for investment firms, trustees and custodians, and providing enhanced safeguards for funds’ investment activities, particularly in relation to derivatives, securities lending, and repo and reverse repo transactions.

In **Australia**, the regulator has introduced tough new “Product, Distribution & Intervention Powers”, as part of the government’s response to the Financial System Inquiry. The rule gives a temporary product intervention power to ASIC when there is a risk of significant consumer detriment.

Pension protections

With the pensions market rapidly moving from the defined benefit model to a defined contribution model, risks are increasingly borne by individuals. This has spurred regulators to consider consumer protection issues in the pensions industry, something that in the past was the preserve of sponsoring companies.

In **Sweden**, following a number of pension “incidents” involving sub-par funds and rogue providers, the government mandated the Swedish Pensions Agency to tighten the conditions for fund companies wanting to



be part of the Pillar I system. The current 850 providers from which pension savers can choose is likely to be substantially reduced. At the time of writing, the Pensions Agency powers were likely to take effect in late 2018.

In **Australia**, where the asset management industry is dominated by the large superannuation funds, the regulator APRA is examining the sustainability of funds and member outcomes. APRA has written to about 30 funds regarded as operating at sub-scale asking for reassurance about their sustainability. It is likely that this focus will lead to rationalization of the sector, which is one of the aims of the regulator.

Data protection regulation is all-pervasive

Possibly the ultimate investor protection regulation – the General Data Protection Regulation (GDPR) – which aims to strengthen individual data protection rights, while ensuring the free movement of personal data across the **EU**, came into force on 25 May 2018.

GDPR applies universally but is particularly onerous for service-oriented companies with large customer registers, such as asset managers. GDPR is a big deal in that it covers any data that could be used to identify an individual, either directly or indirectly. Firms will need to significantly improve the way they develop their operations.

GDPR applies to all firms that are processing data related to the offering of products and services to individuals residing in the EU and this means non-EU based fund managers and distributors come under its scope. Activities such as distributing marketing materials to EU citizens or tracking and analyzing visits to a website, even if that website is hosted outside the EU, could fall under GDPR. For example, using data related to the products an investor viewed online, in order subsequently to market products to that investor, would fall under GDPR.

Firms that fall foul of GDPR face hefty fines, paying up to either EUR 20 million or 4 percent of global turnover, whichever is the largest. Companies must also report a breach to regulators within 72 hours.

Further complexity arises if a firm is transferring data outside the European Economic Area. The Commission has so far recognized countries including **Argentina**,

Canada and **Switzerland** as having adequate rules. At the time of writing, there was no adequacy decision with the **US**, though the US EU privacy shield, which covers transatlantic data flows, may apply.

Aware of the challenges in implementing GDPR, the European Commission in February 2018 issued guidance to asset managers. The Commission also urged member states to speed up the adoption of national GDPR legislation and noted that national authorities should be suitably funded and staffed in order "to guarantee their independence and efficiency."

The Commission pledged to monitor member state compliance and to continue its multi-stakeholder group engagement, with a review of stakeholder experience due in May 2019 and an evaluation report expected by May 2020.

In response, **Switzerland** is updating its Data Protection Act. The revised act is designed to enhance transparency and strengthen individuals' control over their data. It also takes into account the revision of the Council of Europe's Data Protection Convention. Compared to the GDPR, the draft provides no right to data portability, no extra-territorial scope, lower requirements with respect to consent, certification mechanisms and codes of conduct, and limited sanctions.

In the Channel Islands, both **Guernsey** and **Jersey** have enacted data protection legislation to provide equivalence to GDPR. Challenges to meeting the May 2018 deadline were created by conceptual differences in transparency versus privacy legislation. This brings into conflict the need to disclose under transparency legislation, such as the UK Trust register, against the requirements for privacy and data protection under GDPR.

In **Australia**, the Notifiable Data Breaches scheme has made notification of data breaches to the Office of Australian Information Commissioner mandatory. For the first time in Australia, all entities covered under the Privacy Act, including those operating in the asset management industry, now have obligations to report on data breaches, as of 22 February 2018.

And at the end of 2017, the **Indian** government set up a committee of experts to study various issues relating to data protection in India, to make specific suggestions on principles underlying a data protection bill and to draft such a bill. The objective is to "ensure growth of the digital economy while keeping personal data of citizens secure and protected."



Chapter 4

No let-up on costs and charges

In last year's report¹, we described how costs and charges were at the top of the reform agenda in the investment industry. Little has changed in 2018.

Regulators around the globe continue to pursue simple and meaningful cost disclosures for funds, which remain elusive.

Meanwhile, an increasing number of regulators are also scrutinizing the level of costs and charges, with "closet tracking," disclosure of benchmarks and performance fees being headline issues.

And the industry's remuneration practices continue to come under the microscope, with different potential outcomes for asset managers and fund management companies.

¹ <https://home.kpmg.com/uk/en/home/insights/2017/06/evolving-investment-management-regulation-fs.html>

Disclosure of costs is paramount

In **Japan**, the JFSA² introduced in 2017 seven “Principles for Customer-Oriented Business Conduct” (see Chapter 3), among which was a principle of disclosure on fund commission fees. This principle demands that asset managers appropriately manage conflicts of interests, particularly in the case where the distributor receives the payment of a commission fee from the product provider. Another principle clarifies that the details of the fee and other costs borne by the customer should be provided so that the customer can understand the fee.

It requires information about third-party payments to be provided to clients. It includes requirements for distributors to provide to their clients the total cost of ownership: aggregate figures for the costs of investing, both within the product and along the distribution chain. This shows investors what they indirectly pay for the services they receive, allowing them to understand the total costs and to compare different services and financial instruments.

In **Switzerland**, the introduction of FinSA³ brought in rules on how and when to disclose costs and charges to clients.

Meanwhile, in the **EU** under MiFID II⁴, ESMA⁵ expects the industry to use the methodology in the PRIIP KID⁶ for *ex-ante* costs, which includes implicit market risk. Also, it expects UCITS and other funds not currently subject to the PRIIP KID regulation to provide *ex-ante* transaction costs in line with the methodology for new PRIIPs. This methodology is less problematic than the main PRIIP methodology, but it nevertheless includes (or is silent on) a number of aspects that are causing firms practical difficulties in implementation – for example, the current absence of market data.

...but meaningful costs disclosure remains elusive

MiFID II and PRIIPs are central to the costs and charges push in Europe. But all has not gone smoothly. The transaction cost disclosures have produced some extreme figures that are misleading to investors. Morningstar data shows that hundreds of funds apparently have negative transaction costs, while others appear to have excessively high costs. Asset managers and other experts say the results are down to flawed methodology.

Under MiFID II, managers must provide distributors with transaction cost data that includes estimated implicit costs, the difference in the price when the transaction is executed compared with the price when the transaction order is entered. This can result in negative figures.

“managers must provide distributors with transaction cost data”

In fact, more than 580 funds reported negative transaction costs in January 2018, with 36 funds quoting costs of minus 1 percent or less. The European Fund and Asset Management Association (EFAMA) says the inclusion of implicit costs within transaction cost figures “will at best confuse investors and at worst mislead them”.

Asset managers may need some considerable time before they can provide accurate transaction costs. By early 2019, funds will be able to show actual transaction costs over the previous year, which should give a more accurate representation of costs, but critics say the methodology itself needs to be revised.

ESMA is not convinced that revisions are necessary. Steven Maijoor, chair, said in March 2018, “we are ready and willing to look at this issue but [that] we need to see concrete evidence to assess whether these flaws are real. In the absence of any such evidence, we maintain our view that the methodology is sound and that negative transaction cost figures should be extremely rare”.

Fund platforms react to confusion

The MiFID II and PRIIP KID requirements have had a tangible effect on funds. Hargreaves Lansdown, for instance, in January 2018 – just after implementation of the new rules – removed 1,200 ETFs⁷ and 300 closed-ended investment trusts from its platform because they did not comply with the new rules. Hargreaves, the UK’s largest fund supermarket, delisted nearly 100 Europe-domiciled funds and 1,100 funds that are domiciled elsewhere, mainly in the US. It did not expect to reinstate 900 predominantly US-domiciled ETFs and 200 mainly US-registered trusts, as these are unlikely to seek to comply with the new guidelines.

² Japanese Financial Services Agency

³ Financial Services Act

⁴ Markets in Financial Instruments Directive, revised

⁵ European Securities and Markets Authority

⁶ Packaged Retail Investment and Insurance-based Product Key Information Document

⁷ exchange-traded fund

“ impact of fees on fund performance....a significant regulatory topic ”

Similar concerns surfaced around the PRIIPs rules when they came into force in January 2018. The rules are designed to help retail investors understand and compare the key features, risks, rewards and costs of different products through a short document, the KID. However, the scenarios outlining potential returns to investors (stressed, unfavorable, moderate and favorable) are based on five-year performance, which is producing misleading results, says the industry.

In the **UK**, the Association of Investment Companies said it had been inundated by complaints from members that the regulation was forcing them to overstate their performance and understate the risks.

The FCA⁸ responded to the complaints, advising that where a PRIIP manufacturer is concerned that predicted performance may mislead investors, they can provide additional explanatory wording in the KID. Firms selling or advising on PRIIPs could also provide an explanation as part of their communications with clients.

Again, ESMA appears unconvinced that there is an issue with the prescribed methodology, but it is working on further guidance. More generally, a review of the PRIIP KID is scheduled for 31 December 2018, when the European Commission will assess the impact of the regulation.

While the PRIIP KID currently applies only to AIFs⁹ (i.e. non-UCITS¹⁰), EFAMA has repeatedly warned of the issues for UCITS that are the underlying investment components of other PRIIPs. It is also concerned that the rules as currently written should not be extended to standalone UCITS in 2019.

Low tolerance for high fees

The impact of fees on fund performance, particularly on active fund performance, is becoming a significant regulatory topic, with a number of regulators performing assessments.

In **Canada**, regulators completed their investment fund modernization project in 2017, which aimed to ensure that investment fund clients receive comprehensive and transparent information on the cost and performance of their investments. The current project is now focusing on fees and fairness.

In late 2017, a **European** campaign group called on the fund management industry to stop the proliferation of small, expensive funds. The group, Better Finance, found there are 8,700 European funds with assets under management of less than USD 20 million (EUR 17 million), of which a quarter have ongoing charges of 2 percent or more. Among these small funds, 1,200 charge over 2.5 percent and more than 700 charge over 3 percent, it said.

Guillaume Prache, managing director of Better Finance, said: “This is a very important problem as, contrary to common thinking, these small-size funds are often UCITS and are often sold to retail investors without any appropriate warning.”

But assessments of the impact of costs are not easy to gauge, as the European Commission and ESMA discovered.

ESMA apologized for errors in its 2017 report on the effect of fees on fund returns. It originally said that active equity fund returns of 15 percent fall to just 3 percent after costs. However, this figure was found to be incorrect due to a number of typographical errors in the report. In fact, sales charges and inflation lowered active equity fund returns by 3 percent – reducing returns from 15.5 percent to 12.2 percent.

The study also shows that the effect of costs on money market funds is larger than for bond funds, which in turn is larger than for equity funds. However, the regulator did not account for these asset class variations when assessing costs across Europe. For example, the study does not consider whether **Dutch** or **Swedish** investors – who are subject to the smallest cost impact on returns – are more likely to invest in equity funds than **Austrian** or **Belgian** investors – who suffer the largest cost impact on returns. In fact, Dutch and Swedish investors have a larger portion of their assets in equity mutual funds than investors in Austria or Belgium, explaining much of the difference in returns highlighted in the study.

The issue was further muddled by the study’s inclusion of inflation in its analysis, which is questioned by some in the industry.

ESMA is now carrying out a new larger-scale study into the impact of costs on fund performance. It says the first analysis has helped it develop “initial metrics to analyse the impact of ongoing fees, one-off charges and inflation on the returns of mutual funds”.

Meanwhile, in February 2018, the **French** AMF¹¹ published a study on fees charged by French or foreign UCITS distributed in France, based on analysis of information

⁸ Financial Conduct Authority

⁹ alternative investment fund

¹⁰ Undertakings for Collective Investments in Transferable Securities

“ a new larger-scale study into the impact of costs on fund performance ”

found in the funds' key investor information documents (KIIDs) for the financial year 2015 and the disclosed ongoing charges.

The AMF wrote that of the 8,038 funds distributed to the general public, 148 UCITS, representing 0.33 percent of assets under management, disclosed substantially higher charges than their competitors. Among these UCITS, 70 percent had less than EUR 20 million in assets, which likely did not allow them to benefit from economies of scale. In addition, the majority of these funds charged additional fees when their fund manager bought or sold portfolio securities (turnover fees), which increased the level of ongoing charges disclosed in the funds' KIIDs.

The AMF observed that some of these UCITS have since merged or been liquidated, which could be the result of competition from other UCITS that charge lower fees.

In last year's report, we described the interim findings of the **UK** FCA's Asset Management Market Study which uncovered competition issues among platforms, as well as findings of weak price competition and mixed cost control among fund managers. The final report was little changed and the FCA proposed a suite of new rules.

The final rules were issued in April for implementation by 30 September 2018. The boards of fund management companies must include at least two independent directors and appoint someone with direct responsibility for demonstrating value. However, the FCA did not mandate switching to best value share classes and did not introduce an end-date for payments of trail commission to financial advisers.

In July 2017 the FCA said it would explore whether platforms help investors make good investment decisions and whether the investment solutions offer investors value for money. The interim report is expected mid to late 2018.

In **Ireland**, the CBI¹² has included in its 2018 supervisory program a thematic review into practices relating to the charging of performance fees to UCITS. The initial focus is understood to be the calculation of performance fees by administrators and the verification of those amounts by depositaries.

¹¹ Autorité des Marchés Financiers



Also, the CBI is consulting until 29 June 2018 on whether Irish UCITS should be banned from charging performance fees more frequently than once a year. According to the central bank, this requirement would bring the regulator's approach into line with IOSCO¹² recommendations on fees and expenses. Only a small number of Irish UCITS apply performance fees and these funds tend to be aimed at institutional investors.

Closet tracking is still a big deal

The **European** Parliament announced in September 2017 it would conduct a study into closet tracking funds – funds that mirror their underlying indices despite being marketed as actively managed – and potential disclosure failings by UCITS. The parliament's influential Economic and Monetary Affairs Committee commissioned the study, which will be debated by MEPs¹⁴.

ESMA's study in 2016 found that between 5 percent and 15 percent of UCITS equity funds could potentially be closet trackers. Following its probe, ESMA commissioned national regulators to carry out further investigations into the issue.

However, regulators such as **France's** AMF and **Luxembourg's** CSSF¹⁵ found no evidence of closet index funds. The AMF criticized the methodology used by ESMA and said that based on its own analysis there are no French closet trackers. The CSSF said it could not identify any UCITS qualifying as a closet index tracker, apart from "one isolated case".

Better Finance also estimated that roughly 70 of 165 funds suspected of being closet trackers do not disclose benchmark performance and questioned whether they are in breach of EU law. Current regulation requires funds to disclose 10-year performance of their chosen benchmark alongside the 10-year performance of their fund.

The CSSF did note that disclosure in relation to benchmarks could be improved for some of the funds under review and asked the firms concerned "to increase the level of information disclosed in the [KIID] and the sales prospectus".

It is not clear how easy it will be for regulators to make charges of closet tracking stick. The Oslo District Court ruled in January 2018 that a **Norwegian** investment firm did not overcharge investors on three funds. The lawsuit, filed on behalf of 180,000 investors, was the largest class action lawsuit in Norway. Norway's Consumer Council has lodged a formal appeal against the verdict, saying the ruling is not "consumer friendly".

¹² Central Bank of Ireland

¹³ International Organization of Securities Commissions

¹⁴ Member of the European Parliament

¹⁵ Commission de Surveillance du Secteur Financier

“funds that mirror their underlying indices despite being marketed as actively managed”

In **Sweden**, a public inquiry published in 2017, urged greater transparency with regard to how active a fund is and tracking errors.

Meanwhile, ESMA's new study, announced in October 2017, compared active and passive funds. ESMA examined the extent to which active funds beat their benchmarks, and compared active returns against passive products.

The launch of the study followed the publication of the **UK** FCA's report into asset management, which found that active funds provide poor value for money. As a result of the FCA report, the UK regulator said in March 2018 that asset managers should compensate investors who were overcharged for closet tracking funds. Investment firms must notify clients who may have been overcharged. The FCA also demanded that 64 closet tracker funds – out of 84 suspect funds investigated – must change how they market the funds.

Richard Stobo, who was at the time team leader for investment management at ESMA, said the **European** watchdog is “very aware of the work the FCA did and have been looking at [it] closely”.

The FCA report was disputed by the active fund industry, which criticized the methodology and provided evidence that contradicted the FCA's findings.

In the **Netherlands**, the Dutch shareholders association said it fully embraced the ESMA probe into fund fees but warned that it must be transparent in order to allow stakeholders to “verify the results”.

The European Commission in June 2017 also published economic analysis suggesting that retail investors should invest in passive funds. The analysis, which was published alongside the Commission's CMU¹⁶ mid-term review, endorsed efficient markets theory, saying “in effect no other portfolio can have both a higher expected return and lower risk than the total-market portfolio”. Retail investors may therefore be “partially misguided” if they attempt to outperform markets via actively-managed funds.

Although the academic analysis is not a policy position paper, fund representatives were concerned that the Commission appeared to be directing investors towards a particular investment type. The **UK** Investment

Association (the IA) and the **German** asset management trade body (the BVI) both took exception to the Commission's comments. Active and passive strategies both have their merits and “none of them should be in general declared as superior”, said the BVI.

The IA questioned the Commission's use of the S&P Spiva Scoreboard to support its argument that only a small number of professional investors outperform the market. The IA pointed out that only a tiny proportion of European funds use S&P indices as a benchmark.

The focus in **Hong Kong**, on the other hand, is on minimum fund sizes and challenging fund trustees if performance is persistently low. It is said to be closely following the debate in the UK on “value for money”.

Remuneration still under the microscope

Remuneration is another debate, like closet tracking, which continues to raise the hackles of regulators and industry alike.

In **Europe**, CRD IV¹⁷, which came into force at the start of 2017, includes a cap on bonuses for material risk takers at 100 per cent of fixed salary, or 200 per cent where there is shareholder approval. Interpretation of the application of this requirement varies across Europe, and the **Netherlands** imposes a lower cap. The European Commission said it was considering waiving strict banking remuneration rules for some non-banking groups – including asset managers. It wrote to the European Council and European Parliament, saying it would conduct an impact assessment on allowing rule waivers.

However, in January 2018, this process hit a stumbling block after the waiver encountered strong resistance from **Germany**. During an initial discussion of the legislation between EU member states, Germany said the decision to exempt asset managers should be reconsidered.

UK-based asset managers affected by the proposed regime tend to operate under MiFID licenses. Many continental European asset managers, on the other hand, provide asset management services from their fund management companies. They fall under the UCITS Directive or AIFMD capital requirements and are not in scope of CRD IV.

¹⁶ Capital Markets Union

¹⁷ Capital Requirements Directive, revised

Chapter 5

Cross-border distribution is key to competition

Despite best intentions, cross-border distribution of investment funds is far from frictionless.

Even though cross-border distribution has been facilitated by regulation for many years, **Europe** still has not completely cracked the issue. The European Commission has made it a priority for 2018 to remove barriers to creating a more competitive pan-EU investment landscape, including for personal pensions. Elsewhere, a number of countries are establishing new domestic fund structures to compete with foreign options.

Meanwhile, use of the **Asian** fund passports remains low. And "Brexit" will impact cross border flows between the **UK** and the rest of the EU, in both directions. Also, the EU regulatory approach to the provision of portfolio management from one jurisdiction to another – or "delegation" – looks set to become more demanding.

On the other hand, bilateral arrangements have come to the fore and countries such as China and India continue to open up their capital markets to foreign investors.

Removing national barriers to EU fund distribution

The **European** Commission has proposed a so-called omnibus regulation to achieve its objective of creating a more competitive EU landscape. Unless barriers are removed, it reasons, CMU¹, a key EU initiative with much political and regulatory support, cannot be achieved.

According to Commission statistics, about 80 percent of UCITS² and 40 percent of AIFs³ are marketed across borders, but one-third of these are marketed into only one member state, usually the state in which the investment manager is domiciled. A further one-third are marketed into no more than four other member states.

Bringing down barriers within the EU

The European Commission has identified six categories of national barriers that need to be tackled:

- Host states can set national requirements on financial promotion and consumer protection, giving rise to initial research costs for firms and to additional ongoing costs.
- EU funds can be subject to regulatory fees imposed by home and host member states that vary significantly in scale and calculation methods.
- A number of states impose special administrative arrangements to make it easier for investors to subscribe, redeem and receive payments from funds. Some states force funds to use certain institutions and to provide additional information to the regulator and investors.
- Despite the increasing use of online platforms to distribute funds nationally, barriers exist across borders.
- When fund documentation has to be updated, managers are required to give written notice to the host regulator, adding cost and time to the process.
- Different tax treatments create barriers to cross-border business.

“ retail investors should receive the same level of protection, regardless of the location of the firm providing the service ”

The Commission says that the reasons the cross-border fund market remains geographically limited include the concentrated fund distribution channels in individual member states, cultural preferences and a lack of incentives to compete across borders. Also, member states imposed additional national requirements when transposing AIFMD⁴ and the UCITS Directive.

Views differ about how to address the problems. **France** and **Germany**, for example, have expressed reservations about the European Commission's proposals to eradicate barriers to cross-border distribution via legislative amendments. The AMF⁵ notes that the European passport for the distribution of investment funds is a “remarkable success”. It is of the view that remaining limits to cross-border distribution are mainly due to the architecture of national distribution networks, cultural savings habits and fiscal rules. It has identified targeted areas where further clarity on applicable rules would be beneficial and could be achieved by ESMA⁶ guidance.

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

The draft rules issued by the Commission include explicit prohibitions on member states requiring a physical domestic presence by the UCITS management company or AIFM⁷ in order to serve investors in their jurisdiction. Electronic or other means of distance communication may be used instead. It also sets out a precise timetable within which national regulators must communicate decisions on changes to a UCITS's notification, and similarly for AIFs.

The draft regulation also includes rules on marketing communications, publication of national provisions and verification of marketing communications by national regulators, as well as common principles regarding regulatory fees or charges and their publication, and standardization of notifications.

¹ Capital Markets Union

² Undertakings for Collective Investments in Transferable Securities

³ alternative investment fund

⁴ Alternative Investment Fund Managers Directive

⁵ Autorité des Marchés Financiers

⁶ European Securities and Markets Authority

⁷ alternative investment fund manager

ESMA will be required to establish, publish and maintain a database of AIFMs and UCITS management companies, the AIFs and UCITS they manage, and the member states in which those funds are marketed. It must also establish and publish an interactive database showing national fees and charges.

The element that has caused immediate concern among the industry is the introduction of a definition of "pre-marketing" into AIFMD. The Commission seeks to draw a distinction between testing an investment idea or strategy with a professional investor in order to test their interest in an AIF that is not yet established and promoting an established fund without notification in the investor's member state. Questions have been raised about how this definition might work in practice and whether it could have an indirect impact on the working of other pieces of legislation that refer to "marketing" but do not define it.

The bigger policy question, though, is whether yet more rules will have the intended effect – to remove unnecessary "red tape". If relevant provisions are removed from national rule books, one might expect there to be some benefits for both investors and firms. But it is not clear whether, or how, these proposals can address the strong national bias among retail investors, in particular, for home-grown funds or the structural market differences due to the predominance of certain types of distribution channels in different member states. Digital distribution platforms and different generational approaches may smooth out these biases over time, rather than more rules.

In the meantime, might more rules actually lead to more red tape, not less?

Creating competitive fund structures

Regulators are increasingly facilitating structures that allow local firms to compete on the world stage.

Hong Kong plans to launch an open-ended fund company (OFC) structure, as part of the government's long-stated policy of bolstering Hong Kong as a full-service asset management hub. Up until now, the preferred hedge fund structure is an offshore limited liability company, typically domiciled in the **Cayman Islands**.

The advantages of an OFC over a Cayman fund, it says, largely center on the savings in management time and money, and the simplicity in dealing with one jurisdiction instead of two. As an adjunct to the single regulator approach, the SFC is proposing a streamlined application process.

“ might more rules actually lead to more red tape, not less? ”

The legal framework for the establishment of OFCs was set out in the Securities and Futures (Amendment) Ordinance 2016, and is expected to come into force in mid-2018. OFC Rules and a non statutory OFC code were the subject of an SFC consultation in 2017.

Singapore, too, is consulting on establishing variable capital companies ("S-VACCs"), to complement existing fund structures. S-VACCs will be supervised by MAS⁸ and can be singular or umbrella structures. Various requirements of company law will be dis-applied (as is common with variable capital companies elsewhere) and foreign incorporated funds will be able to re-domicile as an S VACC.

With effect from 1 January 2018, various changes to the collective investment scheme (CIS) code came into effect, including enhanced transparency and market discipline requirements. MAS has also introduced specific rules in its CIS code for precious metal funds, which can invest in gold, silver and platinum.

In **Bahrain**, the regulator has sought to provide an alternative domestic fund structure for alternative investments. Laws were enacted to introduce three commonly-used alternative asset class structures: Trust law, the Investment Limited Partnership law and the Protected Cell Companies law. Bahrain became the first country in the GCC⁹ area to introduce such structures into its mainland legislative framework. All the structures fall within the regulatory purview of the CBB¹⁰.

Bahrain also became the second GCC state to establish REITs¹¹ as a regulated investment structure, after the UAE, and the first to introduce an Investment Limited Partnership Law and integrate it in the country's legal system. The move allows investors to establish limited partnerships nationwide, as oppose to only in identified free zones.

In the **UAE**, the aim of regulation allowing the development of listed REITs was to attract more interest from retail investors, who typically cannot buy real assets in many prime locations.

In **Canada**, the CSA¹² have proposed an alternative funds regulatory regime to allow the distribution of non-traditional fund products, such as liquid alternatives.

⁸ Monetary Authority of Singapore

⁹ Gulf Cooperative Council

¹⁰ Central Bank of Bahrain

¹¹ real estate investment trust

¹² Canadian Securities Administrators

Proposed amendments to the Alternative Investment Funds framework in **Cyprus** are expected during 2018, in order further to modernize its legal and regulatory framework. The government is fully supportive of the asset management sector and is proactive in upscaling the framework, to support and promote this evolving industry in Cyprus.

The two most awaited amendments relate to the enhancement of the Limited Partnership vehicle and the introduction of a regime for “registered,” but not authorized, AIFs to facilitate quick and cost efficient fund launches. These can be marketed to professional investors and will be managed by a full scope Cyprus or EU AIFM.

In **Ireland**, the CBI¹³ amended the rules governing loan-originating funds. Previously, these vehicles were prohibited from engaging in activities other than lending and related operations. Following a review of this restriction, the CBI concluded that it is appropriate to allow loan-originating Qualifying Investor AIFs to have broader credit-focused strategies. The rule change, which took place in March 2018, means these funds can now invest in credit and debt instruments, as well as issuing and participating in loans, and participating in lending.

As part of the modernization of the legal framework in **France** for asset management and debt financing, the regime for securitization entities was overhauled. A new type of specialized financing vehicle – the “OFS” – was introduced to operate alongside and complement the existing vehicle. An OFS is a non-tranched AIF that is allowed to raise financing by issuing bonds. OFS managers are subject to the full requirements of AIFMD, benefit from the cross-border marketing passport and are eligible to use the “European Long-Term Investment Fund” label.

In **Germany**, too, the regulator has made changes to the operation of loan funds. It has adopted for all UCITS management companies and AIFMs a new approach towards a holistic internal governance that goes beyond risk management requirements. The new requirements for loan funds are in line with those for banks and include functional and hierarchical separation, voting on loan agreements and sound practices in loan origination.

In **Guernsey** and **Jersey**, the regulators have recently updated the local regulations for the Private Investment Fund and the Jersey Private Fund, respectively. This was in response to market demand for a product designed for relationships between investors and manager that are much closer than that of a typical agent, and therefore a more proportional regulatory regime was thought appropriate.

A changing landscape for personal pensions

Cross-border distribution of investment funds may also be supported by the much-discussed pan-**EU** personal pension product (PEPP). The European Commission issued, in July 2017, the long-awaited draft regulation for the PEPP, which is being debated by the European Parliament and Council.

The PEPP is a voluntary scheme for saving for retirement. The intention is that it will be offered by a broad range of financial companies across the EU and will be available to savers as a complement to public and occupational pension systems, and alongside existing national private pension schemes.

The proposed PEPP requirements cover authorization, distribution, investment policy, switching provider, and cross-border provision and portability. The mechanism behind the portability concept envisages a compartment within each individual PEPP account for the different member states to which the PEPP saver moves over time. These compartments would be adaptable to the different national tax incentives.

Delegated acts are envisaged in the areas of conflicts of interest, inducements, selling PEPPs with and without advice, product oversight and governance, provision of information, investment options and reporting to national authorities. A review of the operation of the regulation is proposed after five years.

The PEPP proposals may not get an easy ride, though. The difference in national tax treatments is difficult to resolve. Also, the Parliament’s lead rapporteur wants to introduce a restriction regarding the way products pay out during the retirement phase, which could limit the ability of fund managers to be PEPP providers.

Things are more promising for **German** asset managers. The law strengthening occupational pensions, which came into force at the beginning of 2018, encourages for the first time the creation of government-subsidised occupational pension plans with defined contributions. The law introduces a ban on guarantees traditionally provided by insurers, which is expected to open up the pension market for asset managers.

In **Japan**, the so-called “Expert Discussion on Stable Asset Formation for Households,” aims to encourage stable pension portfolios by shifting household financial assets into a balanced portfolio. Long-term portfolios have been stimulated with the launch of tax-exempted NISAs (individual savings accounts) in January 2018.

¹³ Central Bank of Ireland

The **Australian** Government continues to consult on a framework for Comprehensive Income Products for Retirement. To facilitate the consultation, the Government announced on 19 February 2018 the establishment of a consumer and industry advisory group, whose primary objective is to provide feedback and advice to the Treasury on possible options.

But not all barriers are coming down

The **European** Commission has still not granted the AIFMD passport to any non-EU countries, despite ESMA's advice in July 2016 that the passport should be given to 12 non-EU countries. The Commission indicated that there are a number of issues to resolve, including taxation and anti money laundering.

It seems likely that third countries might have to wait until deep into 2018 or beyond for progress. The Commission may decide to delay extending the AIFMD non-EU passports until this work is nearer completion. It is an open question whether the delay is also partly due to Brexit.

The issue does not appear to worry the Channel Islands, as the marketing of AIFs is typically limited to no more than four or five member states in over two-thirds of cases. The local industry and its clients say the national private placement regime (NPPR) framework works more effectively in these cases, so the delay in introducing the non-EU passport is not a major concern. **Guernsey** Finance said "this delay in itself has created an additional flexibility for managers seeking options around marketing into Europe. Managing an AIF by using an EU entity allows, and indeed ordinarily requires one to use, the AIFMD passport. Managing from **Guernsey** by contrast still allows managers to use the existing and familiar private placement regime."

The **Jersey** Fund Association agreed. "NPPR is giving non-EU fund managers a really reliable, straightforward and efficient route for marketing alternative funds into Europe. It's stable, it's cost-effective and it's tried and tested. Against a complex geopolitical backdrop in Europe, that's a really attractive proposition for fund managers right across the private equity, real estate, hedge and infrastructure fund asset classes, as well as for institutional pooling vehicles invested in securities."

It is not only NPPRs that are important, though. In **Germany**, for example, guidelines issued by BaFin¹⁴ are viewed by alternative asset managers as a *de facto* ban on German pension funds investing in non-European loan funds.

Asian passporting schemes meet resistance

The various Asian passporting schemes, launched with some fanfare over the past years, have not made rapid progress. While the **China Mainland-Hong Kong** Mutual Recognition of Funds (MRF) is firmly entrenched, flows are scarce. The Asian Region Funds Passport (ARFP) has barely gained any traction either. Cultural and linguistic barriers have combined with currency and capital restrictions to thwart their take-off.

The Monetary Authority of **Singapore** recently signing a Memorandum of Understanding with the Securities Commission **Malaysia** (SCM) and the Securities and Exchange Commission of **Thailand** to enhance the Association of South-East Asian Nations Collective Investment Scheme Framework (the ASEAN CIS Framework). The agreement between the three countries, which incorporates feedback from extensive industry consultations, seeks to promote more cross-border offerings of ASEAN funds and to allow fund managers to offer a broader range of fund products to investors in the region.

The key enhancements will enable a wider range of fund managers to participate in the ASEAN CIS Framework by lowering qualifying criteria from USD 500 million to USD 350 million assets under management, shortening the time-to-market for the launch of funds, and giving fund managers more flexibility to delegate the investment management of a fund.

Will Brexit raise barriers?

Amid efforts to bolster competition in the **European** investment market, there are concerns that the ramifications of the **UK** leaving the EU – "Brexit" – may have a counterproductive effect. Most market participants are agreed that Brexit needs to be managed well to ensure vital market structure and capital market flows are not damaged.

While the investment landscape post-Brexit is as yet unclear, it is apparent that the ramifications of Brexit will be far wider than a simple break between the EU and the UK. A number of MEPs¹⁵ are now calling for a fundamental review of the different "third country" rules in EU legislation, for example. The outcome could have a significant impact on the UK's "equivalence" status post-Brexit and that of all other non-EU/EEA countries.

In last year's report¹⁶, we described the complex issue of how the UCITS, AIFMD and MiFID passports are likely to work post-Brexit. This analysis – undertaken in

¹⁴ Bundesanstalt für Finanzdienstleistungsaufsicht

¹⁵ Member of the European Parliament

¹⁶ <https://home.kpmg.com/xx/en/home/insights/2017/05/evolving-investment-management-regulation-fs.html>

“ the ramifications of Brexit will be far wider than a simple break between the EU and the UK. ”

2016 – still holds true. Indeed, the European Commission issued papers in February 2018 that make the same points about how the legislation works.

However, with the issuing of an opinion by ESMA in May 2017 on principles for the supervisory approach to the relocation of activities from the UK to elsewhere in the EU, followed in July 2017 by more detailed sector-specific opinions, a further and significant issue has arisen: the future regulatory approach to delegation.

ESMA says that no reliance should be placed on firms' existing authorizations and there should be no derogations or exemptions. It adds that regulators should consider carefully their ability to assess documentation presented in a foreign language without appropriate translation.

ESMA also published a letter from Steven Maijoor, ESMA's chair, to Vice-President Dombrovski, inviting the Commission to consider extending its proposed enhanced approach for the recognition of third country central counterparties to other entities. This intervention further underlines that the EU's evolving approach to third countries is a business risk for firms around Europe and elsewhere, as Brexit approaches.

Improving the operation of EU passports

ESMA recommends as good practice that:

- Regulators should consider not only the activities of a ManCo¹⁷/AIFM in their own member state but also its cross-border activities, especially where via a branch
- Regulators should review the compliance of a branch of a ManCo/AIFM not only on receipt of the notification, but on an ongoing basis
- Where AIFMs operate across borders, regulators should take this into account, with the amount of supervisory activity reflecting the size and impact of the AIFM's activity
- Regulators should take into account all the marketing activity of an AIFM, not just that in its own jurisdiction

¹⁷ management company



Delegation debate heats up

The **European** Commission says that "the future departure of the EU's currently largest financial center means that supervisory arrangements must be strengthened to ensure that financial markets continue to support the economy on an adequate and sound basis."

The Commission proposes to mandate ESMA to review the arrangements of firms that intend to make extensive use of delegation or outsourcing to third countries. It would amount to second guessing national regulators' views and has moved to center stage the practice of domiciling a fund in one EU member state and delegating the investment management function to the UK.

The Commission notes that current supervisory practices vary from one member state to another. It argues that

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"we are not looking to question, undermine or put in doubt the delegation model." Steven Maijoor, ESMA Chair

”

this gives rise to regulatory arbitrage (a race to the bottom), with firms benefiting from the EU passport while essentially performing substantial activities outside the EU. It also exposes the EU to financial stability risks, it says, particularly where the third country's supervisory authorities lack the necessary tools to supervise those activities.

It is proposed that where a firm intends to delegate or outsource a material part of its activities or any of the key functions to a third country, the national regulator must notify ESMA, providing sufficient detail to enable ESMA to make an assessment. ESMA has up to two months to issue an opinion. If the regulator chooses not to follow ESMA's view, ESMA must make its view public. It therefore seems unlikely that a national regulator would go against ESMA's opinion, as the firm could face reputational risk.

ESMA has sought to reassure the industry. Its chair, Steven Maijoor, said in March 2018 "we are not looking to question, undermine or put in doubt the delegation model. We know that this is a key feature of the investment funds industry and that the flexibility to organise centres of excellence in different jurisdictions has contributed to the industry's success." He said that



ESMA is seeking to address the risk of letterbox entities and that the opinions "simply clarified what this means in practice and what factors have to be taken into account when assessing whether there is sufficient substance." He observed that national regulators have been interpreting these requirements differently.

Neither is there any indication that ESMA's new powers would be applied retrospectively, but it seems inevitable that the detailed rules on delegation under the AIFMD will be extended to UCITS. The Commission said the lack of harmonization between AIFMD and the UCITS Directive makes it challenging to interpret the two directives "with the same spirit". It indicated that it was open to the idea of creating stricter rules on delegation in the UCITS directive too.

Opposing views come from around the globe

Non-EU countries potentially impacted by rule changes are demanding a say in how the rules are formulated.

Hong Kong's fund trade body, for one, called for non-EU jurisdictions to be able to contribute "meaningfully" to the development of UCITS fund regulation. Sally Wong, chief executive of the Hong Kong Investment Fund Association (HKIFA), said the "growing importance" of Hong Kong as a sales hub for UCITS means European authorities should "bear in mind" the global nature of the product.

Hong Kong is believed to be the fifth-largest market for Europe-domiciled cross-border funds sales. **Singapore** and **Taiwan** have also become significant markets, far outselling the UK, Belgium and France in 2017.

The HKIFA says it has "concerns" and "questions" about the ability of funds to delegate key activities such as portfolio management to third countries.

Some of those concerned about changes in delegation rules, are now seeking international intervention. In December 2017, several associations escalated the matter to IOSCO¹⁸. They hoped that new IOSCO delegation principles would supersede any rules set out by ESMA. IOSCO is reportedly receptive to discussing the rules governing delegation and has made it an "agenda item".

The **UK** is pushing back against any change in approach within the EU. Megan Butler, executive director of supervision for investment, wholesale and specialists at the FCA¹⁹, said she saw "no real justification for unnecessarily complicating rules around delegation and outsourcing".

Ms. Butler said it is "crucial for the UK investment industry and the rest of Europe" to maintain open

markets rather than sacrifice them "as an inevitable response to Brexit". There is already sufficient regulatory infrastructure to supervise delegation arrangements when the UK becomes a third country, she added.

The FCA has found an ally in **Luxembourg**, with the Luxembourg finance ministry saying it planned to "deploy best efforts" to engage with the European Parliament and European Council to contest changes to delegation rules.

ALFI²⁰ said the European Commission's proposals would "add an additional bureaucratic layer to the fund authorization procedure with the involvement of ESMA and as such time to market will be affected". ALFI added: "The delegation model in particular is tried and tested, and has worked in the European fund industry for three decades."

In **Germany**, the BVI²¹ agreed that the proposal to give ESMA a direct role in vetting delegation arrangements is unnecessary. Also, the **Swiss Funds & Asset Management Association** said member firms are worried about the worst-case scenario whereby "delegation is not possible anymore". The association wants clarification of the technical points included in the guidance, such as what "substance" means.

Meanwhile, Paul Stevens, chief executive officer of **US** fund industry trade body, the Investment Company Institute, said Brussels' proposal "risks closing off Europe to third-country fund managers" and "puts at risk the success of UCITS". At a meeting of regulators held in Washington in January 2018, US representatives told their EU counterparts they were firmly against changes to delegation rules.

The AMF in **France** appears to stand on the other side of the argument. Secretary General, Benoît de Juvigny, warned that some EU member states could allow the creation of "letterbox" entities in order to attract UK-based asset managers. Mr. Juvigny said: "In European regulation like [the AIFMD], letterbox entities are forbidden, but we would appreciate some clarification on minimal requirements in terms of resources and presence to locate entities in EU member states." It supports increased powers for ESMA in order to ensure a consistent regulatory approach across the EU to the amount of "substance" required in the delegating entity.

The French industry group, the Association Française de la Gestion Financière, supports the Commission's aim of greater regulatory and supervisory convergence. In particular, it says that delegation or outsourcing to third countries should remain possible as long as the substance of the activity remains in the EU.

¹⁸ International Organization of Securities Commissions

¹⁹ Financial Conduct Authority

²⁰ Association of the Luxembourg Fund Industry

²¹ Bundesverband Investment und Asset Management

A large French asset manager has publicly argued that EU-based managers should be able to outsource all functions to another EU country. However, it says flexibility should not apply to the outsourcing of activities to a non-EU country, which should be subject to a different regulatory framework.

Regulators already flexing their muscles over “substance”

There is already evidence that ESMA is flexing its muscles, with reports in January 2018 that it was investigating substance issues at four firms.

Alos, the CSSF²² in **Luxembourg** is reported to be reviewing firms' ratios of staff and management positions to funds under management.

In **Ireland**, the CBI²³ conducted an evaluation of how it deals with the issues covered by the three ESMA Opinions on outsourcing and delegation of activity by firms, to ensure that its authorization and supervisory processes are materially aligned with the Opinions. A number of procedural enhancements will be made in the near future through the updating of the CBI's application forms and internal procedures. In the interim, these enhancements will be incorporated into the CBI's current authorization process.

The evaluation was in addition to the review of outsourcing arrangements of investment firms that the CBI conducted by issuing a survey of firms in late 2017. Firms were asked to provide information including the types of services and operations outsourced, materiality and concentration of outsourced arrangements, as well as contractual arrangements. The survey informed the subsequent outsourcing provisions contained within the 2017 Investment Firm Regulations and associated Guidance.

UK responds to threat to its asset management sector

The FCA has asked the **UK's** biggest asset managers for information on how they are preparing for Brexit. Partly in response to attempts by other European national regulators to attract UK-based firms to relocate activities. It announced plans to create an asset management hub to support “new entrants” to the UK fund space, in particular with regard to the various regulatory hurdles.

The hub will help start-ups through the pre-authorization and authorization procedures by means of a “user-friendly” support system. The first phase of the program was launched in late 2017, with start-ups offered pre-application meetings and dedicated case officers. The regulator plans

to expand the service throughout 2018, providing quarterly surgeries and online booking for pre application meetings.

In late 2017, the UK government vowed to ensure UK-based asset managers can continue to offer UCITS-like funds after Brexit. In a report, the UK Treasury said it sought to improve the outlook for the GBP 8.1 trillion (EUR 9.2 trillion) UK asset management industry to ensure it remains competitive.

An asset management taskforce comprised of chief executive officers and other stakeholders will meet on a quarterly basis until October 2019, several months after Brexit.

Elsewhere, bilateral cross-border arrangements increase

Faced with a lack of strong progress on investment fund passports, bilateral arrangements continue to be made on other matters. Authorities and industry organizations from **Hong Kong** and **Switzerland**, for example, signed three memoranda of understanding in September 2017, providing for co-operation in RMB internationalization, wealth management, infrastructure financing and fintech.

Hong Kong's SFC²⁴ and **France's** AMF signed a Memorandum of Understanding (MoU) on the France-Hong Kong Mutual MRF, which will allow eligible Hong Kong public funds and French UCITS to be distributed to retail investors in each other's market through a streamlined authorization process.



investors yet to create a substantive footprint in China may increasingly choose this option



In addition, in January 2018, Hong Kong Exchanges and Clearing Limited and NZX Limited of **New Zealand** signed an MoU. The two exchanges are looking to co-operate on foreign investment, derivatives, depository receipts, listed debt, dual listings and exchange traded funds.

Meanwhile, the Monetary Authority of **Singapore** and the **Malaysian** SCM said they would work together to facilitate the establishment of a stock market trading link between Bursa Malaysia and Singapore Exchange by the end of 2018. The trading link will allow investors to trade and settle shares listed on each other's stock market in a more convenient and cost-efficient way.

²² Commission de Surveillance du Secteur Financier

²³ Central Bank of Ireland

²⁴ Securities and Futures Commission

MAS and SCM set up cross-border supervisory and enforcement arrangements, and agreed to work with the two exchanges to get the link up and running.

Japan, a founder member of AFRP, established the Financial Market Entry Consultation Desk to help foreign financial institutions enter the Japanese market. One of the reasons for this is to find a home for the large amounts of capital held by Japanese households. This capital used to be largely kept in bank savings accounts, but these accounts now yield little and more productive investments are sought.

In October 2017, a vision for "International Financial City: Tokyo" was created, from which the Consortium for Japan International Asset Management Center Promotion (JIAM) was established by the Tokyo Metropolitan Government.

JIAM will support emerging domestic and international asset managers. They typically need help obtaining a license in Japan, which can take considerable time. In addition, it is difficult for investment companies to attract funds from investors due to insufficient data on their investment performance. JIAM will co-operate with the JFSA²⁵ promptly to grant licenses to selected asset managers and to provide support for fundraising and IT platforms.

Further market opening in China and India

The proposed easing of ownership limits in **China's** financial sector has aroused interest among investors seeking to gain greater access to the world's second largest economy. Following the November 2017 announcement, foreign investors will be permitted a 51 percent holding (up from 49 percent) in securities brokerages, futures companies and fund management companies. After a further three years, all caps on investment are to be removed.

With 40 or so joint ventures already in place, some foreign players holding minority stakes may renegotiate to gain a controlling position. The opportunity to take a majority slice may also stimulate increased interest in new joint ventures – possibly from investors that have previously been cautious.

Investment management wholly foreign-owned enterprises (WFOEs) can already offer private fund products in China, but in three years' time they might also be able to launch mutual fund products. This makes the WFOE option attractive – investors yet to create a substantive footprint in China may increasingly choose this option.

Meanwhile, at the end of 2017, the **Indian** regulator relaxed conditions for foreign portfolio managers to enter Indian markets.

²⁵ Japanese Financial Conduct Agency



Chapter 6

Creating innovative, competitive environments

Even if divergence is the regulatory watchword of 2018, in some areas of asset management, regulators seem to be in lockstep. Chief among these is the necessity of evolving regulation to facilitate the development of "fintech".

Fintech is becoming a priority for many asset management firms. It has the potential to revolutionize their business models, bringing greater efficiency to financial transactions, for example, and helping firms and regulators meet the increasing demands for data.

In the main, regulators recognize the benefits of new technologies and are seeking to accommodate them. But they are also concerned about existing risks that could be heightened by the new forms of services.

They are also evolving regulation to become more fit-for-purpose in a digital age. "Big data", robo-advice, crowdfunding and cryptocurrencies are all in the regulators' sights.

The sprint for fintech supremacy

The **European** Commission has made provisions for the use of fintech in existing legislation, including in MiFID II¹, the Payment Services Directive and in European Market Infrastructure Regulation. In 2017, it issued a consultation paper on the development of its policy approach towards technological innovation in financial services. It is seeking "a genuine technology-enabled single market for retail financial services".

In March 2018, the Commission launched its FinTech Action Plan. The plan outlines 19 steps to enable innovative business models to scale up, to support the uptake of new technologies, and to increase cybersecurity and the integrity of the financial system.

The steps include setting out a "blueprint" with best practices on regulatory sandboxes and work on a common standard for distributed ledger technology (DLT) to enable connectivity between different networks. The Commission also plans to create a Europe-wide financial technology laboratory, where policymakers can discuss regulatory approaches to new technology in the finance sector.

The Commission believes an EU-wide fintech platform for regulators could address the problems of regulatory divergence across Europe. Several national regulators, including in the **UK**, **France** and the **Netherlands**, have already set up regulatory laboratories, giving rise to a potential slew of different rules across the EU. In **Ireland**, the CBI² announced in April 2018, that it intends to establish an 'innovation hub' for firms, both start-ups and incumbents, to engage directly with the CBI on innovation and FinTech.

The **UK's** FCA³ indicated it would open up its financial technology innovation lab to international regulators. The UK regulator has been operating a regulatory sandbox since 2016 and says it has received a number of membership enquiries from firms outside the UK.

Indeed, in February 2018, the FCA and the **US** Commodity Futures Trading Commission signed a fintech co-operation agreement. The agreement focuses on information sharing on fintech market developments, and pools insights from innovation competitions and sandbox projects. It will allow UK and US fintech players to enter each other's markets without red tape.

Also in February 2018, the FCA proposed a "full multilateral sandbox", structured as an "international college of regulators" already operating their own sandboxes. This would enable firms to conduct tests in different jurisdictions at the same time, and allow regulators to solve common cross-border regulatory problems, said the FCA.

Similarly, MAS⁴ in **Singapore** has signed agreements with authorities in other jurisdictions to foster collaboration in the development of fintech ecosystems and to encourage greater innovation. Bilateral agreements were signed with Egypt and Lithuania in 2018. Other jurisdictions include Denmark, the Philippines, Poland, Malaysia, Thailand, France, Hong Kong and Japan. In addition, MAS launched a SGD 27 million grant to promote the further use of artificial intelligence and data analytics in the financial services market.

Most countries are, for the moment, developing fintech-related regulation at a purely local level. These include **Switzerland**, where FINMA⁵ reviewed its ordinances and circulars, and found them to be largely technology-neutral. It issued a circular to facilitate client onboarding via digital channels (video identification), which came into force in March 2016, and the regulator said it aimed to further a fintech-friendly environment, having launched a regulatory sandbox.

The **French** AMF⁶ said that it will continue to support innovative projects, notably via its dedicated FinTech, Innovation and Competitiveness division, created in 2016, and to discuss changes in the regulatory framework due to new types of offer, in particular Initial Coin Offerings (ICOs). However, it is not keen to adopt a sandbox approach to deal with innovations within Europe and believes that a level-playing field – which might include some element of proportionality – should apply to all players, be they new entrants relying on technology or established players.

In **Bahrain**, the CBB⁷ similarly introduced a regulatory sandbox for fintech. To be eligible to participate, firms must show the CBB that they have an innovative product of tangible benefit to customers and a well-developed regulatory testing plan. Firms must also submit a sandbox exit strategy that demonstrates their intention and ability to deploy the proposed solution in Bahrain. Bahrain currently has six approved fintech firms in the sandbox.

¹ Markets in Financial Instruments Directive, revised

² Central Bank of Ireland

³ Financial Conduct Authority

⁴ Monetary Authority of Singapore

⁵ Financial Market Supervisory Authority

⁶ Autorité des Marchés Financiers

⁷ Central Bank of Bahrain

In addition, the Bahrain Economic Development Board launched the Bahrain Fintech Bay, which it said is the largest dedicated fintech hub in the Middle East and Africa. The new hub aims to further the development and acceleration of fintech firms as well as the interaction between investors, entrepreneurs, government bodies and financial institutions.

In the **UAE**, the Dubai International Finance Centre has undertaken considerable regional advertising for its own fintech sandbox, accompanied with conferences and other events. Meanwhile, the Abu Dhabi Global Market opened what it billed as the first "RegLab" in the region, a tailored regulatory regime for fintech participants.

In **Japan**, the "Online Transactions in FinTech era Research Group" was jointly established by the FinTech Association, Japan Association of New Economy and the JFSA⁸.

In addition, a "FinTech Demonstration Experiment Hub" was set up as part of Japan's "In the Future Investment Strategy 2017". Thematic teams are formed in the hub to address topics such as compliance and oversight risks and practical issues on legal interpretations. A bill to establish a regulatory sandbox was also passed.

In **Canada**, the Ontario Securities Exchange (OSC) created LaunchPad, a dedicated regulatory team which supports fintech businesses; and in **Indonesia**, the regulator's strategic priorities for 2018 include supporting fintech.

The **Guernsey** regulator has established an Innovation Soundbox and the **Jersey** regulator has a Regulatory Sandbox for prospective clients and service providers, where existing or future licensees can discuss and test ideas, innovations or future applications. The Innovation Soundbox has already been used successfully, for example with the recent launch of the world's first private equity blockchain in Guernsey.

DLT attracting plenty of attention

DLT is a potential fintech game changer. It has huge potential implications for settlement of financial transactions, and for firms' back and middle offices. The technology aims to prevent fraud by using a public digital database that is continuously maintained and verified by the other computers in a chain of transactions.

In **Europe**, ESMA⁹ identified possible benefits in clearing and settlement, record of ownership and safekeeping of

assets, reporting and oversight, reduction of counterparty risk, efficient collateral management, continuous availability, security and resilience, and cost reduction. DLT might also be used to enhance pre-trade information and the matching of buyers and sellers.

The European Commission, in early 2018, announced it would invest up to EUR 340 million over the next two years to identify regulatory risks and business opportunities linked to "blockchain" technology. The proposed EU Blockchain Observatory and Forum, launched with the support of the European Parliament, will highlight key developments of DLT, promote European firms and reinforce European engagement with multiple stakeholders involved in DLT activities.

The Commission wants the EU to become a leading world region in the technology. It has been funding projects through the EU's research programs, FP7 and Horizon 2020, since 2013.

The Commission seeks to build on existing DLT initiatives, ensure that they work across borders, consolidate expertise and address challenges, such as disintermediation, trust, security and traceability. It will enable cross-border co-operation on practical use cases, bringing together Europe's various experts and stakeholders, including public authorities, regulators and supervisors.

In **France**, securities not traded via a central securities depository or a securities settlement system can now be represented and transmitted using DLT. The securities covered by the French initiative are equities, debt securities, short-term debt securities and units of collective investment undertakings. The regulatory and legal framework is under construction: the Blockchain Ordinance sets the framework and provides for the use of the technology. It will become applicable by 1 July 2018.

In response, the central securities depository has proposed new fund distribution standards, including encouraging the use of DLT in the sales process, as part of efforts to make French funds more attractive to international investors.

In **Switzerland**, FINMA has been supporting efforts in developing and implementing DLT solutions in the Swiss finance industry for several years. And in **Ireland**, the Department of Finance published a discussion paper on virtual currencies and blockchain technology, and announced the subsequent creation of an internal working group to monitor further developments in this area.

⁸ Japanese Financial Services Agency
⁹ European Securities and Markets Authority

Regulators won’t give fintech a free ride though

Despite the potential benefits, innovation is causing regulators to question whether current rules and supervisory approaches for fintech are fit for purpose.

Caution is increasingly being expressed about the need to address risks in the new technologies. In early 2017, the FSB¹⁰ chair, Mark Carney, warned that some innovations could generate systemic risks through increased interconnectedness and complexity, greater herding and liquidity risks, more intense operational risk and opportunities for regulatory arbitrage. However, in its mid-term review, in July 2017, the FSB concluded that there were “currently no compelling financial stability risks from emerging Fintech innovations”.

Nevertheless, fintech is largely untested and this worries regulators. The **European** Central Bank’s committee on payments and market infrastructures, believes DLT, for instance could pose new risks to the financial system, including uncertainty about operational and security issues. Its report cited potential legal and operational obstacles: “Having many nodes in an arrangement creates additional points of entry for malicious actors to compromise the confidentiality, integrity and availability of the ledger”.

ESMA examines DLT

ESMA has also consulted on the application of DLT, aiming to identify its benefits, risks and challenges in securities markets, and ways of addressing the risks. Before DLT is applied for larger-scale purposes, ESMA is concerned that its legal certainty and broader legal issues – such as corporate, contract, solvency and competition laws – need to be considered and clarified. Key risks identified by ESMA are cyber, fraud, money laundering, operational, herding behavior (increased market volatility) and unfair competition.

The **UK** financial regulator, on the other hand, is worried that DLT could lead to a lack of individual accountability at firms. In a paper on distributed ledgers, published in December 2017, the FCA warned that the collaborative nature of the technology meant it might be difficult to tell who is responsible for decisions.

It said that the use of the technology “might affect how individual responsibility and accountability is allocated”. The regulator said this could be the case even if a firm used a permissioned blockchain, where the number of parties were restricted.

¹⁰ Financial Stability Board

The FCA said firms will have to set out clearly each manager's personal responsibilities, in line with the SMCR¹¹.

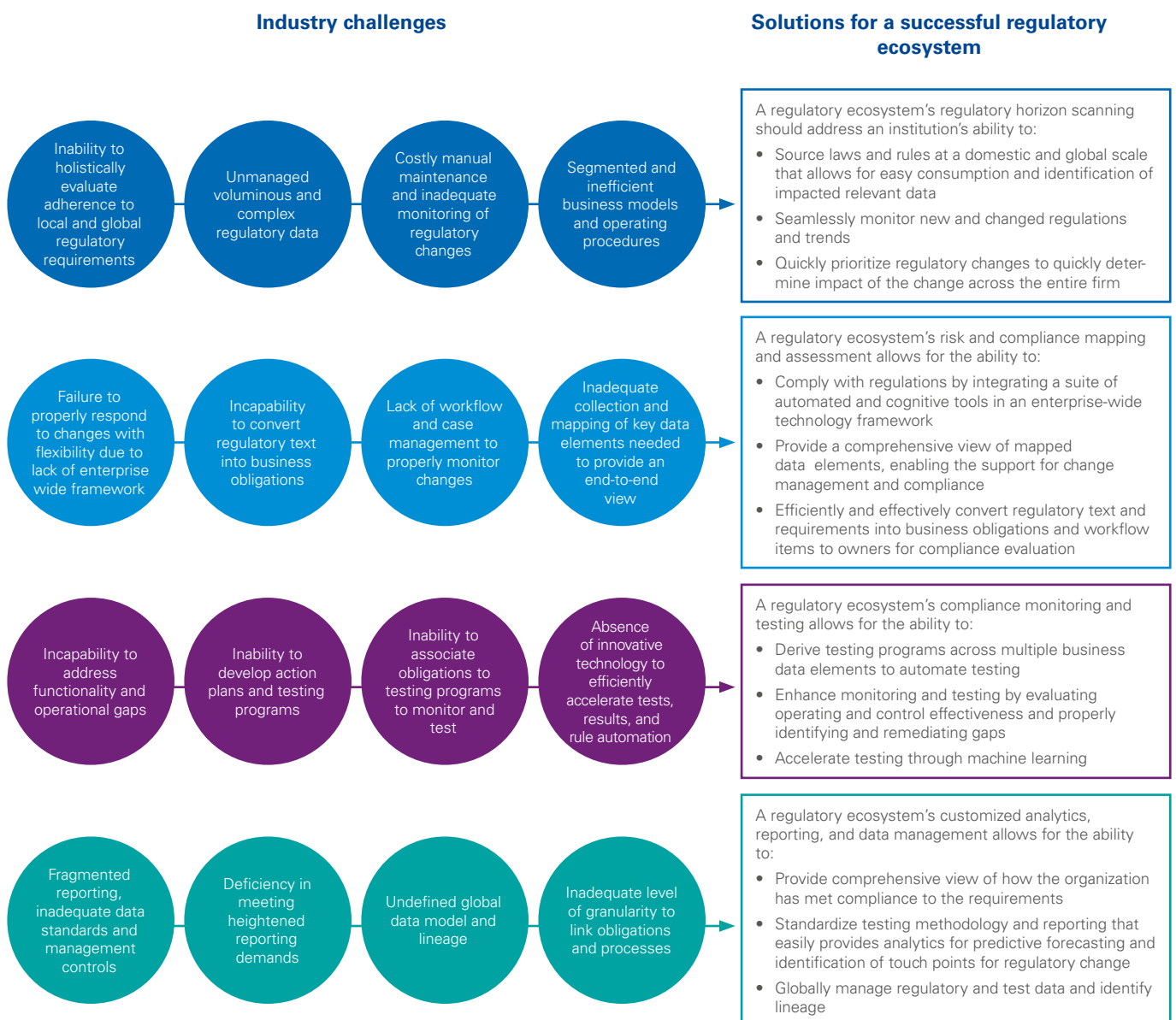
Big data is worrying regulators too. The FSB in late 2017 highlighted the potential risks associated with the growing use of artificial intelligence (AI) and machine learning and warned they must be monitored by regulators. The Basel-based regulator warned that "the lack of interpretability or auditability of AI and machine learning methods could become a macro-level risk," with a "widespread use of opaque models" potentially resulting in unintended consequences.

Another potential risk identified by the regulator is that the use of AI and machine learning could lead to a dependency on third-parties and create "the emergence of new

systemically-important players that could fall outside the regulatory perimeter"

However, the FSB did state that more efficient processing of information would make the financial system more efficient.

In **Bahrain**, the CBB has brought the outsourcing cloud services within its regulatory purview. It has mandated certain minimum security measures that must be in place before a cloud outsourcing arrangement can be undertaken, including encryption of customer information, maintenance of a secure audit trail and that the release of customer data to foreign governments or courts is the sole responsibility of the licensee and subject to CBB approval.



¹¹ Senior Managers Certification Regime

Cybersecurity remains a top priority

Cybersecurity is another essential component of the regulatory view of fintech.

In **Singapore** in September 2017, MAS established a cybersecurity advisory panel, comprising thought leaders from around the world. The panel will advise on strategies to enhance the cyber resilience of the Singaporean financial sector. In November 2017, MAS and the Financial Services Information Sharing and Analysis Centre launched a pan-Asia Pacific initiative to share cyber threat information in a timely manner and to enable a rapid and co-ordinated response to emerging threats. And in February 2018, the government passed a Cybersecurity Bill with new powers for the Cyber Security Agency.

ESMA announced it would create a forum for senior supervisors in the **EU** during the course of 2018 to help develop common approaches to cyber security and cyber resilience. The move follows a call by the European Commission for regulators to examine cyber resilience, citing cyber-attacks as a key threat to financial stability.

In **Germany**, BaFin¹² said it would add rules and principles on cybersecurity to secure the roll-out of digital strategies of UCITS¹³ and AIF¹⁴ management companies.

The issue is taken seriously the world over. In **Bahrain**, the CBB has recently mandated that cyber security controls are periodically evaluated for adequacy, taking into account emerging cyber threats and establishing a credible benchmark of cyber-security controls.

The CBB also requires reporting to it any instances of cyberattacks, whether internal or external, which compromise customer information or disrupt critical services that affect firms' operations. The reporting should be accompanied by the root cause analysis of the cyber-attack and measures taken by them to ensure that events do not re-occur.

The **UK's** FCA has proposed a requirement for independent directors of fund management company boards to address the "under-reporting" of cyberattacks. Megan Butler, the FCA's director of supervision for investment, wholesale and specialists, said during a speech in late 2017 that the UK regulator expects "candour" from financial firms, particularly on cyberattacks. She said: "Our suspicion is that there's currently a material under-reporting of successful cyberattacks in the financial sector."

In **Australia**, APRA¹⁵ has published a consultation on a prudential standard on information security to address the growing threat of cyberattacks. The proposed standard

includes requirements on governance, capability, controls and detection mechanisms. It also includes assurance over the cyber capabilities of third parties, such as service providers, and improving entities' ability to respond to and recover from cyber incidents.

In April 2018, the three **European** Supervisory Authorities (ESAs) issued a report on risks and vulnerabilities in the financial sector. Cyber risks have become a "significant and highly escalating threat to investor protection, the financial markets and their stability worldwide," they said. They called on financial institutions to improve their IT systems and explore risks to information security, connectivity and outsourcing.

Big data continues to attract the interest of regulators

It seems that no discussion of technology is complete without reference to "big data." The ESAs believe the phenomenon has the potential to grow and that a firm's capacity to use big data may be a key determinant of its future competitive advantage. Having consulted in early 2017, the ESAs issued their final report in March 2018.

The ESAs define big data as the collection, processing and use of high volumes of different types of data from various sources, using IT tools, in order to generate ideas and solutions or to predict certain events or behaviors. They observe the increase in the use of big data, albeit to varying extents across the sectors and across the EU. They recognize that its use could transform the way products and services are provided, which could provide benefits for consumers and financial institutions.

However, there are attendant risks. The potential for errors could lead to incorrect decisions taken by financial services providers, for example, and the increasing segmentation of the customer base is influencing market and product access. The ESAs note that consumers should be made aware of the risks.

Taking into account the benefits and the risks associated with the use of big data, the ESAs have concluded that any legislative intervention at this point would be premature. They note that existing legislation should mitigate many of the risks identified (see the discussion in Chapter 3 on new data protection rules, for example). They will, however, continue to monitor developments and invite financial firms to develop and implement good practices on the use of big data.

¹² Bundesanstalt für Finanzdienstleistungsaufsicht

¹³ Undertaking for Collective Investments in Transferable Securities

¹⁴ alternative investment fund

¹⁵ Australian Prudential Regulatory Authority

Robo-advice comes under regulatory scrutiny

Robo-advice is being scrutinized by regulators across the globe as the numbers of platforms and users increases. The key regulatory concern is that consumers should receive appropriate advice, the same as in the traditional face-to-face advice business model. The use of technology raises the added concern that, if there is an error in the programming or technological process, it may not be picked up without human intervention. Also, consumers may presume that their inputs and the computer must be right without question or double-checking.

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

Singapore, for example, recognizes the gaining popularity of digital advisory services and welcomes such offerings to complement existing advisory channels. MAS has proposed amendments to regulations to address the unique characteristics and risks of such services. It is concerned with the minimum standard of client care, governance and management oversight, and that the methodology should be sufficiently tested and robust.

In **Europe**, EFAMA¹⁶ has urged ESMA not to impose more onerous rules for an investment service "that is quite similar [to face-to-face advice], though provided through digital means".

EFAMA highlighted a resolution adopted by the European Parliament's Economic and Monetary Affairs Committee in 2017 that said: "the same consumer protection requirements should apply to robo-advice as to face-to-face advice". It disagrees with ESMA's recommendation that robo-advice firms need to focus on providing sufficient information to clients given the "limited" – or even non-existent – human interaction these firms have with end-investors.

ESMA recommends that robo-advisers provide information on the algorithm they use, an explanation of the degree of human involvement in the service, and how the firm will use suitability information to develop a solution for the end-investor. But EFAMA warned that further disclosures for robo-advice companies may have an adverse effect, leading to information overload.

In **Germany**, the BVI said that the implementation of the additional requirements would require firms to carry out "an extensive re-modelling of existing websites and client onboarding." According to the BVI, one of its members estimated that such a process would cost about EUR 3.5 million and take up to a year to undertake.

In the **Netherlands**, the regulator found major shortcomings in the way robo-advisers onboard new clients. It warned that some robo-advisers are placing too much responsibility on clients by requiring them to determine their own risk profiles. "Many businesses simply use a digital version of their hard copy question list to determine their client's investment goals and risk appetite," said the regulator. "Failing to accommodate for the differences between physical and online advice, such as the absence of human contact, generally doesn't produce sound advice."

Bitcoin encounters skepticism

Unsurprisingly given their volatility, bitcoin and other cryptocurrencies have encountered considerable skepticism in the investment industry. The **US** has pointedly refused to give the green light to funds based on cryptocurrencies. Dalia Blass, a director at the SEC¹⁷ sent a letter in February 2018 to two firms, containing more than 30 questions that needed to be resolved before the SEC would allow the launch of mutual funds and ETFs¹⁸ that invest in cryptocurrencies.

Ms. Blass's letter was a response to numerous applications from ETF providers to launch funds tracking cryptocurrencies. In December 2017, two exchange operators, CBOE Global Markets and CME Group, launched bitcoin futures markets, spurring a handful of ETF providers to submit new applications.

The US regulator also raised concerns over the potential lack of liquidity if investors rushed to redeem their shares if bitcoin remained volatile.

In **Japan**, the Coincheck hack in January 2018 has triggered considerable regulatory scrutiny. Hackers stole more than USD 500 million in virtual currency from Coincheck, a cryptocurrency exchange. In the wake of the attack, Japanese regulators announced on-site inspections at all unlicensed cryptocurrency exchanges.

However, official regulatory moves were supplanted by swift self-regulation. Just a few weeks after the hack, 16 exchanges had put together a self-regulatory regime, which governs exchanges previously registered with the JFSA. The new regime replaced an earlier plan to merge two bodies – the Japan Cryptocurrency Business Association and the Japan Blockchain Association.

¹⁶ European Fund and Asset Management Association

¹⁷ Securities and Exchanges Commission

¹⁸ exchange-traded fund

The ICO market has come under regulatory scrutiny as the source of all potential cryptocurrency funds.

In view of the development of fundraising based on the use of crypto assets and DLT, and the risks associated with these transactions, the **French** AMF consulted on three possible supervisory options for a specific legal framework for ICOs:

1. Promote a best practice guide without changing existing legislation
2. Extend the scope of existing texts to treat ICOs as public offerings of securities
3. Propose new legislation adapted to ICOs

Option 3 received the strongest support, attracting nearly two-thirds of responses. In addition, there was unanimous support for an information document for buyers of tokens, which should include, at a minimum, information on: the project related to the ICO and its advancement; the rights conferred by the tokens; and the accounting treatment of funds raised during the ICO.

The AMF continues to work on the design of a flexible and tailored framework for ICOs, which could take the form of an optional authorization regime together with the delivery or not of a visa from the regulator.

Switzerland's FINMA is relatively positive on ICOs. In late 2017, it issued guidance stating that ICOs may be subject to financial market laws depending on the characteristics of the ICO on a case-by-case basis. Potential links to collective investment schemes legislation may arise where the assets collected as part of the ICO are managed externally. New guidance from FINMA regarding ICOs and tokens was published in March 2018. Among other pronouncements, the guidance established that tokens qualify as securities if they are "standardized and suitable for mass trading". However, FINMA added that the issuance and trading of tokens will be analyzed on a case-by-case basis.

In the Channel Islands, the **Jersey** Commission also sought to clarify the regulatory treatment of ICOs. A Jersey company issuing digital coins or tokens in Jersey now needs to obtain a consent from the Commission prior to setting up the operation. For consent to be given, the Commission considers the marketing material, which must contain clear consumer warnings highlighting that the ICO is unregulated and may result in substantial risks.

In **Guernsey**, the regulator has noted that "virtual or cryptocurrencies could interact with our regulatory laws in a number of ways and therefore any application would need to be assessed on its individual merits."

European Commission Vice President Valdis Dombrovskis in December 2017 warned retail investors against buying bitcoins.

Meanwhile, **Germany** and **France** called for international scrutiny into digital currencies amid concerns that a "lack of clarity for investors ... can only fuel speculation". The two countries issued their call in a letter to the G20.

BaFin outlines cryptocurrency risks

The German regulator views the key risks for investors as:

- Total loss
- Regulatory risks: up until now, most ICO issuers have not been regulated or supervised
- Lack of specific investor and consumer protection
- Information insufficiency: ICOs do not provide information for investors that is comparable to prospectuses or key investor information documents
- Opaqueness and complexity: being based on complex technological mechanisms, ICO structures remain opaque for most investors
- Volatility and liquidity risks: the value of coins is volatile and potentially illiquid as there are no secondary markets
- Operational risks: ICOs are prone to fraud, from wrongfully-drafted contracts, theft of private keys and abuse of program codes

BaFin supported a warning on ICOs by ESMA and issued several warnings of its own on consumer protection in relation to cryptocurrencies, in late 2017. It highlighted potential fund management impacts. It saw open issues around the qualification of coins and tokens as financial instruments or transferable securities, as well as the authorization requirements for fund management companies.

BaFin believes ICO risks may be mitigated by applying a robust regulatory environment on issuers of ICOs. It points to ESMA’s consideration of whether ICO structures may qualify as AIFs. That would mean ICO issuers falling under the umbrella of the AIFMD. Alternatively, coins or tokens may qualify as financial instruments under MiFID II. This, in turn, could lead to them being eligible assets for UCITS.

Formal consultations on the regulatory environment of ICOs, cryptocurrencies and relevant derivative products have not yet been set by BaFin but are expected over the course of 2018. A clue to the direction of BaFin’s thinking was provided, in April 2018, by its authorization of a fund investing in cryptocurrencies and blockchain technologies. Meanwhile, there is an increasing number of calls for ESMA to propose a pan-EU approach.

Crowdfunding gets its own rules

In **Singapore**, MAS simplified the rules for securities-based crowdfunding platforms to facilitate start-ups and small- and medium-sized enterprises. In particular, it simplified the pre-qualification checks that platforms must perform on investors and reduced the capital and operational risk requirements of the platform operators.

Under its FinTech Action Plan, the **European** Commission has issued a proposed regulation of crowdfunding. Crowdfunding improves access to funding, especially for start-ups and other small businesses, it says. A start-up can present its project on an online platform and call for support in the form of a loan (peer-to-peer lending) or equity. Investors receive a financial return for their investment.

The Commission observes that it is currently difficult for many platforms to expand into other EU countries. This is why crowdfunding in the EU is underdeveloped as compared to other major world economies, the Commission claims, with one of the biggest hurdles being the lack of common rules across the EU. This considerably raises compliance and operational costs and prevents crowdfunding platforms from expanding across borders.

Once adopted by the European Parliament and the Council, the proposed regulation will allow platforms to apply for an EU label based on a single set of rules, enabling them to offer their services across the EU. Investors on crowdfunding platforms will be protected by rules on information disclosures, governance and risk management, and by a coherent approach to supervision.

“

...currently difficult for many platforms to expand into other EU countries

”

Meanwhile, in February 2018, the **French** AMF published a position-recommendation on the marketing of security and mini-bond offers and the run-off management of platforms. It applies to crowdfunding investment advisors and investment services providers offering crowdfunding advice. It integrates the major principles already published by the AMF on marketing of financial products to retail clients and adapts them to the specific online nature of crowdfunding.

Technology by the regulators, for the regulators

It is perhaps natural that regulators seek to use technology to perform their role, similar to the firms they supervise. **Japan** is one of the jurisdictions leading the way in this regard.

In **Canada**, the OSC hosted the first regulatory “hackathon”, in which fintech firms collaborated on finding solutions to everyday problems that impact the work of the OSC.

The **UK**’s FCA is another national regulator seeking views on how it can use new technologies to facilitate reporting to it by authorized firms. In its Call for Input, in February 2018, the FCA outlined how its “proof of concept” approach was developed at its TechSpring event in November 2017. It asked for views on how it can improve the process, seeking feedback on the role technology can play in regulatory reporting.

The consultation closes on 20 June 2018, and a statement summarizing the views received and the proposed next steps is due to be published in the following months.

Chapter 7

Sustainable finance moves into the regulatory mainstream

Until recently, sustainable investing was considered a matter only for asset managers and investor preferences. This is changing, as regulators increasingly see it as their business to promote asset management that does societal good (or, at least, does not do bad).

Sustainable finance has become a regulatory imperative. Initiatives relating to environmental, social and governance (ESG) factors and socially-responsible investing (SRI) have received regulatory support in several countries.

As institutional investors increasingly ask more questions about ESG and SRI – in part prompted by their own beneficiaries' demands, in part by regulatory suasion – the long-standing debate about whether consideration of ESG factors or SRI fits with fiduciary responsibility is evolving.

ESG and fiduciary responsibility – the tide is turning

Does consideration of ESG factors fit with fiduciary responsibility? This question – which has vexed pension funds, investment managers and lawyers for many years – was raised again by an OECD¹ report in 2017 on investment governance and the integration of ESG factors. It drew a distinction between SRI and the consideration of ESG factors in investment decisions.

The key message was that ESG issues are now critical to the health and prospects of any company. Their consideration therefore sits squarely within an institution's fiduciary duty.

This evolving view has profound implications for firms' investment decision-making processes and has prompted new activity by regulators and policy makers.

Fiduciary standards and their application vary across different legal systems, cultures and contexts, but the common aspects are duties of care and loyalty on fiduciaries to beneficiaries, a focus on behavior and processes rather than outcome, and flexible and adaptable interpretations of fiduciary duty. Historically, courts of law and investors have interpreted the duties of care and loyalty as requiring fiduciaries to consider only the financial interests of beneficiaries, but the definition of beneficiaries' financial interests is evolving.

Rather than fiduciary duty being a barrier to the integration of ESG factors in investing, the changing tide of social and investor sentiment and new laws indicate that consideration of ESG factors will soon become a must for all fiduciaries.

Climate change, for example, is increasingly seen as an important driver of portfolio risk and return. According to the OECD, research suggests that the potential long-term economic cost of climate risks in particular could be high and that pension fund portfolios are especially susceptible given that the bulk of their returns are explained by market movement.

The OECD observed a growing consensus, supported by academic research, that financial markets reward good ESG performance by companies. It recognized, though, that a lack of commonly accepted analytical methods was hampering wider integration of ESG factors into investment processes.

Linking corporate responsibility activity to the UN Sustainable Development Goals (SDGs)

The SDGs have resonated strongly with businesses worldwide in less than two years since their launch. Many already connect their CR activities to the SDGs.

43%
of G250 reporters
39%
of N100 reporters

This is a clear trend that has emerged in a short space of time and strongly suggests that the SDGs will have a growing profile in CR reporting over the next two to three years.

A revision to Japan's Stewardship Code demands:

- Effective oversight by asset owners
- Management of conflicts of interest
- Engagement in passive management
- Enhanced disclosure of voting records
- Self-evaluation by asset managers.

The **Netherlands**, too, has enhanced its corporate governance code to encourage long-term value creation and high-quality corporate culture within investment firms, including fund management companies. Institutional investors and investment companies must give notice, in the director's report or on the website, of compliance with the principles and best practice provisions of the code.

¹ Organisation for Economic Co-operation and Development

Regulators take up the ESG baton

The Government Pension Investment Fund in **Japan** set up a partnership with World Bank Group in late 2017 to promote sustainable investments. Joint research is being conducted on practical issues, such as benchmarks, guidelines, rating methods, publication frameworks, report templates and risk analysis. And in September 2017, the first ETF² dedicated to ESG investments was listed on the Tokyo Stock Exchange.

Guernsey has launched a new initiative called the Guernsey Green Fund and is consulting with industry to establish a bespoke regulatory framework for sustainable and impact investments, which they hope to launch in late 2018.

The **European** Commission carried out a study, which ended in early 2018, into institutional investors' and assets managers' duties regarding sustainability. The high-level expert group on sustainable finance, appointed by the Commission, made eight recommendations, one being that the Commission should clarify that the fiduciary duties of institutional investors and asset managers explicitly integrate ESG factors.

The objective is to ensure that material sustainability factors are consistently taken into account and disclosed by institutional investors and asset managers. It is argued that this will improve investment processes, increase transparency around sustainability in the investment process and reduce costs for end-investors.

The duties of care, loyalty and prudence are already embedded in obligations under various pieces of EU regulation. However, the Commission believes it is unclear that these obligations require assessment of the materiality of sustainability risks. In addition, there is a lack of transparency on how sustainability factors are factored into the investment process. End-investors may not get the full information they need to inform their own investment decisions.

The Commission was also concerned that the interpretation of institutional investors' and asset managers' ESG duties left too much room for differing approaches by member states.

In the event, the Commission's action plan for sustainable finance, published in March 2018, steered clear of strict legal ESG requirements. Instead, it proposes to ensure that ESG factors are "consistently taken into account" in the investment process of institutional investors and asset managers.

In their April 2018 report on risks and vulnerabilities in the financial services sector, the European Supervisory Authorities recommended that financial institutions consider sustainability risk in their governance and risk management frameworks and develop responsible, sustainable financial products.

² exchange-traded fund



“ consideration of ESG factors will soon become a must for all fiduciaries. ”

And in May 2018, the Commission issued legislative proposals to implement its Action Plan. The proposals include requirements on the labeling of products (to enable investors to identify which are “green”), new categories of benchmarks and incorporating sustainability considerations in investment advice.

Initiatives have also taken place at individual member state level.

In **Sweden**, the results of a public inquiry published in 2017 led to a standard for reporting to improve transparency in sustainable investment. The standard asks for information on:

- The sustainability aspects taken into account in management
- The methods used for sustainability investment
- Information to be available on the fund company website.

The Swedish regulator has decided not to regulate so far, allowing the Swedish Investment Fund Association to take the lead through the standard.

Luxembourg sought to deepen its offering by agreeing climate finance initiatives with **China** in September 2017. The International Institute of Green Finance, the Central University of Finance and Economics, the Luxembourg Stock Exchange and China Securities Index jointly launched the CSI 300 Green Leading Stock Index. The index is intended to be a benchmark for measuring the performance of green Chinese-listed companies.

The Luxembourg and Shanghai Stock Exchange also launched the first green bond channel between the two countries, enabling SSE-listed green bonds to be displayed on the Luxembourg Green Exchange.

In December 2017, **France’s** AMF³ published its second report on SRI, including compliance with the requirement for institutional investors and asset managers to publish an annual report explaining how they incorporate ESG criteria in their investment policies and their exposure to climate risks, as well as their contribution to achieving the objectives of energy transition (i.e. comply or explain).

It found that one-third of management companies complied, one-third explained and the remaining one-third were non-compliant within the deadlines. The AMF is concerned that SRI market is “dominated” by institutional investors, with the wide range of SRI vehicles making the market “difficult to understand” for non-professional investors.

³ Autorité des Marchés Financiers

To make it easier for investors to differentiate between SRI funds and conventional funds, the AMF urges fund managers to publish their voting at the general meetings of the underlying companies, to draw up a report on their dialogue with firms and to publish portfolio securities on their websites.

Nevertheless, **Germany** and France have both argued against introducing new EU rules and capital requirements to boost green and sustainable finance in the EU. Better exchange of market information was more desirable, they said.

"Financial regulation or deregulation is not the appropriate tool to ... stimulate specific types of green or punish brown investment," said Levin Holle, director general of financial markets policy at the German finance ministry. By way of example, Holle highlighted the FSB's creation of the Task Force on Climate-related Financial Disclosures, which has commented on opportunities and financial risks from climate change.

The European Commission was listening. Its May 2018 package of legislative proposals did not include provisions on reductions to capital requirements. The Commission is discussing with the European Parliament whether to take this proposal forward given the views among the Finance Ministries.

Workforce diversity moves onto the regulatory agenda

Alongside ESG, regulators are calling for greater diversity in the investment industry. In **Europe**, ESMA⁴ wants investment managers to set diversity targets for their workforce. The drive, announced in September 2017, comes via corporate governance guidelines issued by ESMA and the European Banking Authority (EBA), and were set to enter into force in June 2018.

ESMA and the EBA said diversity should be "taken into account in the process for selecting members of the management body". Financial institutions should "engage a broad set of qualities and competences" when recruiting members to the management body and implement policies to promote diversity. Greater diversity, they argue, reduces "group think" and fosters "independent opinions and constructive challenging in the process of decision making".

The Central Bank of **Ireland** has warned firms that it will consider introducing new gender diversity requirements if regulated firms do not take steps to increase diversity levels on a voluntary basis. It believes that an increased gender balance in firms' boards and management can help ameliorate issues such as "groupthink, insufficient challenge, poorly assessed risk and problems with culture."

"This issue is simply too important to overlook. So regulatory tools clearly have their place," said deputy governor, Sharon Donnery.



"Financial regulation or deregulation is not the appropriate tool to ... stimulate specific types of green or punish brown investment." Levin Holle, German Finance Ministry



⁴ European Securities and Markets Authority

EAMR abbreviations

AI	artificial intelligence	FMCC	Fund Manager Code of Conduct (Hong Kong)
AIF	alternative investment fund	FSB	Financial Stability Board
AIFM	alternative investment fund manager	FSOC	Financial Stability Oversight Council (US)
AIFMD	Alternative Investment Fund Managers Directive (EU)	GCC	Gulf Cooperative Council
ALFI	Association of the Luxembourg Fund Industry	GDPR	General Data Protection Regulation (EU)
AMF	Autorité des Marchés Financiers (France)	HKIFA	Hong Kong Investment Fund Association
AML	anti-money laundering	IA	Investment Association (UK)
AMLD IV	Anti-Money Laundering Directive, revised (EU)	ICO	initial coin offerings
APRA	Australian Prudential Regulatory Authority	IOSCO	International Organization of Securities Commissions
ARFP	Asian Region Funds Passport	JFSA	Japanese Financial Services Agency
ASEAN	Association of South-East Asian Nations	JIAM	Consortium for Japan International Asset Management Center Promotion
ASIC	Australian Securities and Investments Commission	KIID	Key Investor Information Document (EU)
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)	KYC	know your customer
BEAR	Banking Executive Accountability Regime (Australia)	MAS	Monetary Authority of Singapore
BVI	Bundesverband Investment und Asset Management (Germany)	MEP	Member of the European Parliament
CBB	Central Bank of Bahrain	MiFID II	Markets in Financial Instruments Directive, revised (EU)
CBI	Central Bank of Ireland	MiFIR	Markets in Financial Instruments Regulation (EU)
CFA	chartered financial analyst	MMFR	Money Market Funds Regulation (EU)
CFTC	Commodity Futures Trading Commission (US)	MoU	Memorandum of Understanding
CIMA	Cayman Island Monetary Authority	MRF	Mutual Recognition of Funds (China Mainland-Hong Kong)
CIS	collective investment scheme	NAV	net asset value
CMU	Capital Markets Union (EU)	NBNI	non-bank non-insurer globally systemically important
CPD	continuing professional development	G-SIFI	financial institutions
CRD IV	Capital Requirements Directive, revised (EU)	NISA	Individual Savings Accounts (Japan)
CSA	Canadian Securities Administrators	NPPR	national private placement regime
CSSF	Commission de Surveillance du Secteur Financier (Luxembourg)	OECD	Organisation for Economic Co-operation and Development
DFSA	Dubai Financial Services Authority (UAE)	OFC	open-ended fund company (Hong Kong)
DLT	distributed ledger technology	OSC	Ontario Securities Commission (Canada)
Dodd-Frank	US Dodd-Frank Wall Street Reform and Consumer Protection Act	OFS	Organisme de Financement Specifique (France)
DoL	Department of Labor (US)	PEPP	Personal Pension Product (pan-EU)
EBA	European Banking Authority	PRIIP KID Regulation	Packaged Retail Investment and Insurance-based Product Key Information Document Regulation (EU)
EFAMA	European Fund and Asset Management Association	REIT	real estate investment trust
EIMR 2017	Evolving Investment Management Regulation (KPMG International) https://home.kpmg.com/xx/en/home/insights/2017/05/evolving-investment-management-regulation-fs.html	SCM	Securities Commission Malaysia
ESAs	European Supervisory Authorities	SDG	sustainable development goal
ESG	environmental, social and governance	SEC	Securities and Exchanges Commission (US)
ESMA	European Securities and Markets Authority	SFC	Securities and Futures Commission (Hong Kong)
ESRB	European Systemic Risk Board	SMCR	Senior Managers and Certification Regime (UK)
ETF	exchange-traded fund	SRI	socially-responsible investment
FCA	Financial Conduct Authority (UK)	SRO	self-regulatory organization
FINMA	Financial Market Supervisory Authority (Switzerland)	S-VACC	Singapore Variable Capital Company
FINSA / FinIA	Financial Services Act and Financial Institutions Act (Switzerland)	UCITS	Undertaking for Collective Investment in Transferable Securities (EU)
		VCFM	venture capital fund manager
		WFOE	wholly foreign-owned enterprise (China)

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