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Through a new lens

Evolving Asset Management Regulation report

June 2021

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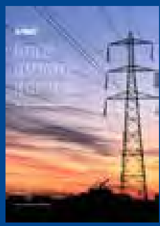
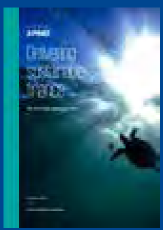


Remote governance and controls



Delivering sustainable finance

Ensuring stable capital markets

Financial resilience in banking: a balancing act

Accelerating digital finance

Redefining operational resilience

Contents

Executive summary

Policymakers and industry are looking at issues through a new lens. The pursuit of economic growth, changing investor demands and behaviors, and environmental and social concerns are influencing regulatory agendas. Of paramount importance are financing sustainable recovery and adjusting regulation for an increasingly digital world and hybrid working models.

Market events in 2020 and ongoing concerns about stability in the capital markets are causing regulators to reassess risks and redefine resilience. Good governance and appropriate investor protection remain regulatory imperatives and are being reinforced and recalibrated. There is even closer supervisory scrutiny in retail markets but an easing of regulations for professional clients.

Regulation is also enabling new market opportunities. New fund vehicles are being introduced as jurisdictions compete for share of market growth, private and real assets are being accommodated to aid economic recovery, and newer capital markets are opening further to foreign investment and firms.

Sustainable finance is the issue most discussed by regulators, industry and investors around the world. International policymakers are focused on sustainability risks, especially of climate change, and want more data and more consistent reporting. Specific requirements for asset owners and asset managers about their processes, and regarding disclosures to investors and beneficiaries, are being introduced or are under discussion. Meanwhile, investor demand for sustainable investment strategies and products continues to rise, along with supervisory scrutiny. Regulators are concerned about "greenwashing", and some are underlining the need for diversity and inclusion within firms.

The pandemic has been a technological catalyst. Initial lockdown measures to manage the pandemic caused years of change to take place in months, as firms moved quickly to large-scale remote working. The pandemic has also provided added impetus to policymakers' plans to encourage moves towards **digital** finance and the widening use of technology. Regulators are attuned to new and emerging risks, as well as the benefits, and are considering how to adjust regulation accordingly.

The asset management and investment funds industry has remained broadly resilient, despite the most extreme market conditions in living memory, and has seen remarkable recovery since the "dash for cash" in March 2020. However, a small number of open-ended funds had to suspend dealing temporarily, in the face of heavy redemption activity and difficulties in selling assets in volatile and sharply falling markets. Regulators are concerned that lessons should be learned and **risks reassessed.** There is special focus on liquidity management in open-ended funds and asset valuations, with bond funds, money market funds, exchange-traded funds and real estate funds all coming under increased scrutiny.

In the new post-pandemic reality, operational **resilience** is being redefined. It is seen as the outcome of effective management of operational risk and is becoming a key driver of investment and business strategy. When identifying potential disruptions to business, firms need to consider not if, but when. Additional demands on systems and processes arising from prolonged and large-scale remote working, and increasingly digitalization, have increased the focus on firms' technological resilience. Some jurisdictions are introducing new capital requirements for investment managers, with the aim of better defining minimum financial resilience.

Supervisors are reinforcing the need for **good governance** of firms, including board composition and engagement, clear management responsibilities and individual accountability. Traditional risk management, oversight and controls are challenged by large-scale remote working. The trends towards sustainable investment strategies, alternative asset classes and digitalization bring with them added complexity to business models and challenges to current operational processes. Product governance is also under the spotlight, together with firms' behavior in the capital markets and stewardship of client assets.

The perennial question for regulators about the optimal level of **investor protection** is now set against the backdrop of the social impacts of the pandemic, the need to encourage greater private investment to aid economic recovery, and the widening use of technology and increased digitalization. These drivers are calling into question whether investor protection rules need to be recalibrated, to capture better the broad spectrum of investors. Disclosure of costs and charges remains a regulatory imperative and is joined by concerns about advertising and marketing, and the treatment of vulnerable customers. While much of the regulatory focus is on the mass retail markets, some regulations are being eased for professional or accredited clients.

New fund vehicles are being introduced, or existing structures adjusted, to compete for market share and to cater for private investment in long-term assets. Many jurisdictions continue to open their capital markets to foreign firms and investment, providing **new investment opportunities.** On the other hand, the commercial and operational implications of the new EU-UK border continue to evolve and could have wider impacts on the industry's global delegation model.

Firms need to reconsider all aspects of their business models to ensure they are fit for purpose in the evolving new reality.

> "... firms need to consider not if, but when"

Questions for CEOs

- Do we have a clear, robust and nimble ESG strategy, supported by our governance arrangements, risk management, investment process, data capabilities and disclosures?
- Are we identifying, measuring and managing risks arising from new technologies and increased digitalization? Are we using technology effectively, to enhance client services and run our business more efficiently?
- Have we critically analyzed experience during the 2020 market stress and reassessed liquidity risk management for each open-ended fund? Do our policies, controls and documentation meet supervisory expectations?
- Is operational resilience a business priority and integral to our business strategy? Have we identified critical business services, from the perspectives of the firm and potential impacts on stakeholders, and are our third-party relationships well-managed?
- Do we have effective Board engagement and supporting governance arrangements? Are our risk management framework and controls fit-for-purpose given continued remote working? Are our product governance arrangements subject to robust and objective challenge, and delivering good customer outcomes?
- Can we evidence a client/investor-centric approach throughout our business? Do we seek to minimize costs incurred by clients/investors and to maximize the value of our services and funds? Are all our disclosures and marketing clear, fair and not misleading, and would they stand up to independent scrutiny and challenge?
- Are we considering opportunities to invest in new markets and asset classes or to use new fund vehicles? If yes, do we have the necessary skills and resources?

01. Refocusing regulatory agendas

Work plans of policymakers and regulators reflect a shift in priorities due to the pandemic. Analysis of market events in 2020 is causing regulators to reassess risks and redefine resilience. But of equal importance are financing sustainable recovery and adjusting regulation for an increasingly digital world, while ensuring good governance and appropriate investor protection.

The Financial Stability Board's (FSB's) 2021 work programme and the International Organization of Securities Commissions (IOSCO's) 2021 work plan cover all these themes, which are also informing national supervisory and enforcement activities.

At global level, work on **sustainable finance** is largely focused on climate change risks, but some policymakers are considering wider ESG (environment, social, governance) issues. The FSB is exploring ways to promote globally comparable, high-quality auditable standards of disclosure on climate risks. IOSCO is engaging with the International Financial Reporting Standards (IFRS) Foundation on the proposed Sustainability Standards Board. It will advance discussions on an ESG assurance framework, and issue reports on disclosures by issuers and asset managers, and on ESG ratings and data providers.

The rapid growth in **digitalization**, especially via social media, has changed the way financial products are marketed and distributed, providing new opportunities for domestic and cross-border offerings. IOSCO is developing policy measures to mitigate the risks posed by online activities and continues to explore how artificial intelligence and machine learning are being used by the industry.

The FSB continues to work on enhancing the understanding of **systemic risks** in non-bank financial intermediation (NBFI) and policies to address these risks. IOSCO, working in tandem with the FSB, is considering fragmentation in the securities and derivatives markets, liquidity risk management, fund valuation, leverage, money market funds and exchange-traded funds. Also, IOSCO will report in mid-2021 on the findings of its thematic review of the impact of the growth of passive investing on equity capital markets.

With increased remote working, potential for cyber-attacks has increased. The FSB is exploring further harmonization of reporting by financial institutions to their regulators or supervisors. And with the aim of improving firms' **resilience**, IOSCO will issue reports on operational, cyber-security and business contingency planning risks, and on fraud and scams.

IOSCO recognizes the challenges posed to regulators and industry by lockdown measures and the expected continuation of large-scale remote working. It is focusing on **conduct** and **investor protection** issues, including misconduct risk. It will also report on the findings of its thematic review of conduct-related issues in relation to index providers, including the potential impact of administrative errors on funds and conflicts of interest.

Local priorities reflect global themes

The agendas of regional and national rule-makers and supervisors reflect these global themes, but with different relative priorities and volume of activities. These differences are influenced by the breadth and depth of the investment industry in the jurisdiction, the types and demands of investors, and economic and social imperatives, including **competition**.

For example, the **European** Commission's agenda includes large packages of measures on sustainable finance and digital finance, as well as seeking to increase non-banking financing within the EU and undertaking reviews of five major pieces of post-2008 financial crisis legislation. The European Securities and Markets Authority's (ESMA's) program for 2021 reflects *"movement of the regulatory cycle towards supervision and enforcement"* and a continued need to develop EU capital markets, *"reinforced by the fact that the largest capital market [the UK] has left the EU".* Much of the program will directly or indirectly impact investment managers and investment funds.

Strengthening supervision

In several jurisdictions, supervisors are increasing the level of inspections and thematic reviews of the industry, for example in **Belgium** and **Italy**. Some supervisors are restructuring their operations, acquiring new powers or adjusting their supervisory frameworks in order to focus on emerging risks.

The Monetary Authority of **Singapore** (MAS) has consulted on new powers to improve effectiveness in addressing financial sector risks. Similar provisions for various classes of financial institutions will be consolidated into a single piece of legislation, which will:

- Include additional powers to prohibit unsuitable individuals from working in the financial industry
- Expand the scope of anti-money laundering and countering the financing of terrorism requirements to persons in Singapore who provide digital token services overseas
- Strengthen the framework for technology risk management
- Improve the effectiveness of dispute resolution

The Division of Examinations of the **US** Securities and Exchanges Commission (SEC) has expanded its ability to respond to new and emerging risk areas with a new Event and Emerging Risks Examination Team (EERT). The Division will leverage this new team to engage proactively with registered firms and other market participants about emerging threats and current market events, and quickly to mobilize expertise and resources to the SEC's regional offices when critical matters arise.

The **Isle of Man** Financial Services Authority has published its Enterprise Risk Tolerance Framework, which explains how

The **European** Supervisory Authorities' first risk assessment report of 2021 recognizes that the financial sector has so far proved financially resilient, but notes that the longer the pandemic continues, the more likely it is that there will be spill -over effects from the real economy into the financial sector. Also, the authorities remain concerned that macro-economic uncertainty is not reflected in asset valuations and market volatility.

Therefore, they warn that:

— Supervisors, policymakers and financial institutions should continue to develop further actions to accommodate a "low-for-long" interest rate environment and associated risks

— Financial institutions and supervisors should be prepared for an expected deterioration of asset quality

— Investment funds should further enhance their preparedness in the face of potential increases in redemptions and valuation shocks

it assesses risks and the impact this has on its decision-making processes. Risks are considered under three broad categories: risks internal to the regulator; external risks in the environment; and risks relating to regulated entities and those subject to oversight. The framework includes detailed processes for the identification, assessment and management of those risks.

On the advice of the International Monetary Fund, the **Chilean** Financial Market Commission (CMF) has restructured its functions and adopted the "Twin Peaks" model of prudential and conduct regulation. Implementation will take place throughout 2021. The intention is to strengthen the CMF's supervisory model and its capabilities to monitor the solvency of financial intermediaries, market conduct and customer protection. The restructuring follows recent similar moves elsewhere – for instance, in **South Africa** – and is consistent with the model adopted in many other jurisdictions.

In response to two critical independent reports, the **UK** Financial Conduct Authority (FCA) has:

— Strengthened its management structure by bringing its Policy, Supervision and Competition functions together under two new Executive Directors, appointing a new Chief Operating Officer, its first Chief Data, Information and Intelligence Officer and an Executive Director of Authorisations.

— Announced a "use it or lose it" exercise to identify firms not reporting income against some of or all their regulatory permissions.

— Introduced mandatory staff training, recruited additional and specialist expertise, and updated policies and staff training in its Consumer Hub.

— Launched the next phase of the "Scamsmart" investment campaign (which warns consumers of the increased threat of clone investment fraud), updated criteria for its Warning List (which alerts consumers to potential action and fraud) and published its first Investment Harms report.

— Launched its first Whistleblowing external communications campaign.

Improving clarity and operational efficiency

Firms around the globe complain, occasionally or frequently, that requirements are not clear or are too complex. Some reviews of post-2008 crisis regulation are seeking to address this. In **Canada**, for example, the Ontario Securities Commission (OSC) is progressing a burden reduction initiative called "Project Rid". Through stakeholder consultations in 2019, it identified 34 concerns and committed to 107 initiatives to address them. The aim is to enhance competitiveness and to save time and money for registrants and other market participants, while protecting investors. The OSC's September 2020 progress report said it had completed 21 initiatives against nine of the 34 concerns.

Also, the Investment Industry Regulatory Organization of Canada (IIROC) has been working on a Plain Language Rule Book, which is expected to be effective from end-2021. The work is based on reviews and regulatory reliefs granted but does more than codify existing practice. There are some changes of substance, including account appropriateness, client verification, adviser training and supervision, and trading authorities over personal accounts (if more than five). Also, regulatory staff must have job titles that are meaningful and transparent to customers.

Regulators are trying to keep abreast of change in the way they perform their supervisory and enforcement activities, including taking advantage of technology to improve the efficiency of their own processes, revamping their websites and adopting new data collection methods. They are increasingly using technology – "SupTech" – to interrogate the reports and submissions they receive from firms and to monitor market activity. Lockdown measures caused many regulators to move to electronic-only communications with regulated firms. Indications are that this will remain a feature going forward.

During the second half of 2020, the **US** SEC adopted a series of measures to streamline processes, for the regulator and firms. An expedited application review process provides clarity for funds, creates a faster and more time-certain process, and will help foster innovation in the industry. Adopted rules have streamlined the creation of a fund of funds, while including safeguards to prohibit an acquiring fund from controlling or exerting an undue influence over an acquired fund, to prevent the charging of duplicative fees and to limit overly complex structures. Electronic signatures are now allowed when executing authentication documents filed with the SEC, and electronic filing and servicing of documents is required in administrative proceedings.

The **French** Autorité des Marchés Financiers (AMF) is progressing its #Supervision 2022 strategy. This includes the launch of an extranet application, "ROSA", which will facilitate information exchange between the AMF and regulated firms. It will reduce the volume of changes that require prior authorization and will enable the AMF to shift its focus towards ex-post reviews. Moreover, as part of a broader re-organization, the AMF has created a new Data and Surveillance Directorate, which will help the AMF to apply a risk-based supervisory approach and be more effective in its use of data.

> "supervisors are increasing the level of inspections and thematic reviews of the industry"

The **UK** FCA is undergoing a transformation program, especially around its use of data, so that it can sustainably oversee the 60,000 firms under its remit. It is making significant investment in technology: moving fully into a cloud environment; bringing all data together in a "data lake"; and recruiting data science expertise. The improvements will enable the regulator to move faster in identifying firms and individuals who are more likely to cause harm, as demonstrated by how the FCA already tackles market abuse in trading markets. It expects that tougher action at the point of application and against poorly performing firms will reduce the number of firms failing and, in turn, reduce costs for the rest of the industry and customer harm.

Key messages

— **Firms need to respond to the common global themes arising from regulatory agendas but to navigate local differences in emphasis and detailed requirements.**

— **Firms need to be prepared for and to respond constructively to increased supervisory scrutiny, across all their operations, both individually and collectively.**

— **Supervisors are moving to electronic means of accepting regulatory submissions from firms and communications with them. They are also increasing their capabilities in analyzing those reports and other market data, which could point to further increases in data requests and supervisory scrutiny.**

02. Requiring sustainable finance

Five years ago, this topic received one brief mention in our report. In 2021, it is the issue most discussed by regulators, industry and investors around the world. Plans are underway for the next COP26 meeting in November 2021, against a backdrop of the ongoing pandemic. International policymakers are focused on sustainability risks, especially of climate change, and want more data and more consistent reporting. Meanwhile, investor demand for sustainable investment strategies and products continues to rise.

The search for common global definitions, corporate reporting standards and metrics has gathered pace. The state-of-play on specific financial services regulation remains mixed, with the EU at present in the lead on imposing detailed rules on asset owners and asset managers about their processes, and regarding disclosures to investors and beneficiaries. However, regulators in other jurisdictions are now proposing new requirements, and supervisory scrutiny is increasing.

A focus on climate change risk

The International Monetary Fund's Global Financial Stability Report of April 2020 says *"Disasters as a result of climate change are projected to be more frequent and more severe, which could threaten financial stability".* The report finds the impact of large physical disasters on equity markets generally to have been modest over the past 50 years, but notes that aggregate equity valuations as of 2019 did not reflect the predicted changes in physical risk under various climate change scenarios, which suggests that investors do not pay enough attention to these risks. The report argues that better disclosures and stress testing for financial firms can help preserve financial stability and should complement policy measures to mitigate and adapt to climate change.

In a letter sent to the G20 finance ministers and central bank governors ahead of their April 2021 meeting, Financial Stability Board (FSB) Chair, Randal Quarles wrote that addressing issues related to climate change *"is essential to a sustainable recovery from the COVID event and beyond."* The FSB is to report by July 2021 on ways to promote consistent, high-quality climate disclosures based on the recommendations of its Task Force on Climate-Related Financial Disclosures (TCFD), and on the data necessary for the assessment of financial stability risks and related data gaps.

The International Organization of Securities Commissions (IOSCO) has committed to issue three reports on:

— Disclosures by issuers, by end-June 2021

— Disclosures by asset managers, with attention to "green washing", by end-2021

— ESG (environment, social, governance) ratings and data providers, by end-2021

An increasing number of central banks and regulators around the globe are joining the debate. For example, the Bank Negara **Malaysia** and Securities Commission Malaysia issued a joint statement entitled "Towards Greening the Financial Sector for 2021". They will build on these initiatives to strengthen the financial industry's capacity in managing climate-related risks and to enhance its role in scaling up green finance. The Central Bank of **Mexico** is asking companies for climate-related data, and the National Bank of **Hungary** has issued a challenging Guideline on Green finance.

In September 2020, the Dubai Financial Services Authority (DFSA) opened a debate on the most suitable ways to prompt the development of sustainable finance in the Dubai International Financial Centre (DIFC), with a view to serving the objectives of Dubai and the **UAE** while facilitating and energizing the activities of the DIFC financial sector.

In March 2021, Ravi Menon, Managing Director of the Monetary Authority of **Singapore** (MAS) said that the future of capital is green and there are three powerful forces driving this: growing recognition of climate change as a global priority; advances in approaches to sustainable investing; and changing investor preferences. And in May 2021, **Japan** released Transition Finance Core Principles. It is expected that activities to transition enterprises from brown to green will be boosted by investors adopting these principles.

Investor demands increase and issuers respond

Investors – from sovereign wealth funds and large institutional investors, to individuals with modest amounts to invest – are increasingly asking questions of companies and investment funds about their ESG credentials. Two, of many, examples illustrate this trend.

In **Australia**, a superannuation fund settled out of court with an individual, who said the fund was not taking climate change seriously. The Employees Provident Fund (EPF), **Malaysia**'s largest retirement fund, aims to base all its investments on ESG considerations by 2030, in the belief that a strategy of holding sustainable assets will make it more resilient against future market upheavals. It is understood to be asking brokerage firms to incorporate ESG considerations into their research process alongside traditional financial metrics.

> "... significant increases in the number and size of green funds."

Issuers and fund managers are responding. There are significant increases in the number and size of green funds. The Climate Bonds Initiative – a not-for-profit, investor-focused organization – reports that 2020 was a record year for the green bond market and that issuance could double during 2021. The market is spreading. Many green bonds have been issued in **Thailand** and the first ever ESG-compliant Sharia debt security (green sukuk) was issued in **Saudi Arabia** by a large utility company, with more such issuances expected.

Search for common reporting standards

Corporate reporting authorities around the globe are at different stages in incorporating into their requirements the TCFD recommendations. The TCFD's October 2020 status report noted that, despite significant sign-up by companies to the recommendations, disclosure of the potential financial impact of climate change on companies' businesses and strategies remains low, that only one in 15 companies reviewed disclosed information on the resilience of their strategy, and that asset manager/asset owner reporting to their clients/beneficiaries is *"likely insufficient".*

The trustees of the International Financial Reporting Standards (IFRS) Foundation have announced plans to establish a new board for setting sustainability reporting standards. It will focus on information that is material to the decisions of investors and other creditors, initially on climate-related matters, and will build on the TCFD recommendations. The announcement was welcomed around the globe but delivering widely accepted standards will not be an easy task.

One of the many questions to be considered is whether the standards should focus only on financial factors or give equal weight to sustainability risks and financial factors – "double materiality". The **EU** has enshrined this concept throughout its ESG-related regulation but recognizes that some leeway is needed in jurisdictions where ESG investing is less developed. Other jurisdictions recommend a focus on financial factors, due to the challenges of determining what constitutes a negative environmental or social impact in different jurisdictions.

Another key question is what is meant by ESG factors. The TCFD focuses on climate change. The UN Sustainable Development Goals and the framework of the Sustainability Accounting Standards Board (SASB) – a not-for-profit industry organization – cover all three factors. The EU's Taxonomy is written into law. At present it covers only E but will be extended to cover S, and is increasingly detailed, at over 500 pages and climbing. It is the compulsory dictionary for EU entities for any corporate reporting, company policies, or company or product disclosures. Progress in finalizing the detailed "Level 2" rules for the climate change mitigation and adaptation objectives has been difficult. In addition to industry concerns, member states have differing views on how nuclear power and gas should be classified.

EU asset managers that are listed or "large public interest entities" will be required to include in their company annual reports the proportions of their turnover and expenses that relate to environmentally sustainable activities. The European Securities and Markets Authority (ESMA) recommended to the European Commission that in-scope asset managers should report based on the proportion of assets under management, for both collective investment funds and separately managed accounts. The Commission has proposed a new Corporate Sustainability Reporting Directive, which will cover many more firms and require further disclosures.

Japan's corporate governance code requires premium-listed companies to disclose against the TCFD recommendations, on a "comply or explain" basis. The **UK** has introduced similar rules (which capture some asset managers) and the government is considering requiring a wider set of companies to publish annual "resilience" statements. It is consulting on whether these could provide a means for companies to provide disclosures consistent with the TCFD's recommendations. **Guernsey** will adopt the EU Taxonomy and will permit insurers a lower capital hit for green investments, including funds. **Hungary**, likewise, is reducing capital requirements regarding specific types of green loans and bonds.

ESG considerations

Environmental
Your impact on the world

- Climate change
- Natural resource depletion
- Waste and pollution
- Deforestation
- Hazardous materials
- Biodiversity

Social
Your contribution to your communities

- Working conditions, including slavery and child labour
- Impact on local communities
- Conflict regions
- Health and safety
- Employee relations and diversity
- Products and mis-selling
- Data protection

Governance
How you conduct yourself

- Executive pay
- Bribery and corruption
- Political lobbying and donations
- Board diversity and structure
- Tax structure
- Data breaches

The US re-enters the debate

US Treasury Secretary, Janet Yellen presided over her first meeting as head of the Financial Stability Oversight Council at end-March 2021. The public portion of the agenda included climate change and its potential impacts on financial stability.

In March 2021, the US Securities and Exchanges Commission (SEC) sought public input on its effort to expand requirements for corporate disclosure of ESG issues and climate risk. The SEC posed questions about data and metrics that cut across industries, the extent to which an industry-specific approach should be used, the existing voluntary climate disclosure, and how a disclosure framework can be flexible enough to keep up with the latest market and scientific developments.

In the same month, the SEC created an enforcement task force on climate and ESG issues, which will develop initiatives to identify ESG-related misconduct. It will look for material gaps or misstatements in issuers' disclosure of climate risks, and will analyze disclosure and compliance issues related to ESG strategies used by investment managers and funds. The SEC also established a web page to help the public keep track of the regulator's ESG-related activity. The site is part of the agency-wide response to soaring demand from investors for information about climate and ESG issues.

EU ESG rules expand in scope and detail

The **EU** Sustainable Finance Disclosure Regulation (SFDR) must be implemented on dates ranging from March 2021 to end-2022 and is one part of a wider package of ESG rules impacting asset managers and asset owners (including investment funds). The SFDR requires companies to disclose whether and how ESG factors are integrated into investment decisions, and by end-2022, whether and how adverse impacts are considered. Each investment strategy or fund must be classified into one of three categories. The company-level and product-specific disclosures must be included in pre-contractual documents, periodic reports and on firms' websites. Also, firms must publicly disclose how their remuneration policies are consistent with the integration of sustainability risks.

> “Each investment strategy or fund must be classified into one of three categories.”

Detailed Level 2 rules, including mandatory reporting templates, should have been issued by end-2020 and still await final adoption by the Commission, but the March 2021 deadline was not delayed. Further, ESMA has consulted on rules to underpin the additional requirements for "light green" and "dark green" products under the SFDR, which were introduced via the Taxonomy Regulation. ESMA recognizes that firms face several practical difficulties:

— Lack of data, especially on principal adverse impacts
— Fitting the additional disclosures into products with length-constrained pre-contractual information documents
— For managers of separately managed accounts, balancing the website disclosure requirements with client privacy and data protection rules
— For smaller firms, meeting growing compliance costs, due to lack of economies of scale

The Commission has issued amendments to existing rules under the Markets in Financial Instruments Directive (MiFID II), the UCITS[1] Directive and the Alternative Investment Fund Managers Directive (AIFMD). In addition to clarifying implications of the SFDR, firms will need to consider clients' ESG wishes in suitability assessments and incorporate consideration of sustainability risks into their investment risk processes, product governance and conflicts of interest policies.

Firms must consider conflicts that might arise from remuneration or personal transactions of relevant staff, or between funds managed by the same firm, and whether conflicts could give rise to greenwashing, mis-selling or misrepresentation of investment strategies. The new Investment Firms Directive (see chapter 5) also requires asset managers to incorporate ESG risks into their governance arrangements and internal risk frameworks.

> "... prescriptive minimum green investment thresholds for products."

The Commission continues to work on an EU Eco-label for investment products, which will set prescriptive minimum green investment thresholds for products, over and above the SFDR fund classifications. The **German** Ministry of Finance has said it will launch a sustainability traffic light system for retail funds if an EU-wide label is not forthcoming. The aim is to make it easier for savers to invest with environmental and social criteria in mind. The system could be based on audited sustainability reports and SFRD disclosures.

The Commission has consulted on an EU Green Bond Standard (GBS) and whether a similar standard should be developed for social bonds. The GBS would apply to any type of issuer: listed or non-listed, public or private, European or international. EU asset managers and funds will need to review bonds in their portfolios that are currently classified using industry standards.

The EU GBS will be based on four components:

— Alignment of the use of the proceeds from the bond with the EU Taxonomy
— The publication of a Green Bond Framework
— Mandatory reporting on the use of proceeds (allocation reports) and on environmental impact
— Verification of compliance with the Green Bond Framework and allocation reports by an external registered/certified party

Luxembourg has already anticipated market trends and investor demand. In September 2020, it launched its Sustainability Bond Framework, which has been designed to comply with the draft EU GBS and incorporates eligibility criteria that are fully in line with the recommendations of the final report of the Commission's Technical Expert Group on the EU Taxonomy. The framework will enable the issuance of green, social or sustainability bonds (i.e. combining green and social aspects). Meanwhile, there are calls for EU regulation to be extended to ESG data and rating providers. To prevent misallocation of investment and greenwashing, and to ensure investor protection, the **French** and **Dutch** regulators have called for a framework of internal control processes, transparency of methodologies and management of conflicts of interest.

France imposes additional requirements

In July 2020, the **French** Autorité des Marchés Financiers (AMF) updated its "Doctrine", which aims to help investors understand sustainable funds by requiring consistency between what is said within marketing material and what is done in terms of ESG portfolio management. Non-French funds marketing in France and wishing to make non-financial criteria a key element of their marketing communications must now complete a new form as part of the passport notification file sent to the AMF by their home regulators. The form enables the AMF to see whether the requirements are met and, if they are not, that the disclaimer provided for in the Doctrine has been included in fund marketing materials.

The AMF considers the Doctrine to be complimentary to the SFDR, noting that both are aimed at preventing greenwashing. However, fund managers expressed concerns about the wording differences between the two texts and the need to perform a double analysis in the same timeline, increasing costs. The AMF may reassess the Doctrine depending on the final SFDR Level 2 rules.

1. Undertaking for collective investment in transferable securities

In February 2021, the AMF introduced a new sustainable finance certification and added more questions on ESG topics within the general professional examination. The aim is to enable professionals to explain the fundamentals of sustainable finance to their clients when identifying their ESG preferences.

Elsewhere, ESG rules emerge

Switzerland is considering whether to apply EU ESG rules to its own firms and funds. To date, the **UK** Financial Conduct Authority (FCA) has encouraged firms to conform with industry standards issued by the UK Climate Financial Risk Forum, but FCA guiding principles are now expected to be published by end-2021 and a UK "taxonomy" by end-2022 .

In December 2020, the MAS issued environmental risk management guidelines for asset managers in **Singapore**. The Guidelines aim to enhance the resilience of investment funds (including real estate investment trusts) and the discretionary mandates of asset managers, by setting out sound environmental risk management practices. They cover governance and strategy, research and portfolio construction, portfolio risk management, stewardship and disclosure of environmental risk information.

Firms should have in place a clear allocation of responsibilities for management of environmental risk in accordance with the three lines of defense model. The Board and senior management should maintain effective oversight of the manager's environmental risk management and disclosure, and the integration of environment risk into the manager's investment risk management framework.

> "... a clear allocation of responsibilities for management of environmental risk."

In assessing environmental risk (on an initial and ongoing basis), firms should consider both transition and physical risks for an individual asset or across a portfolio, refer to international standards and frameworks, and apply risk criteria to identify sectors with higher environmental risk. Firms are expected to exercise sound stewardship to help shape the corporate behavior of investee companies, through engagement, proxy voting and sector collaboration.

Incorporating ESG factors

- ESG strategy & governance
- Corporate reporting
- Client preferences and suitability
- Investment process and strategies
- Data on assets and calculation of exposures
- Investment risk management
- Product governance
- Disclosures, about products and to clients
- Information to and from distributors
- Remuneration policy and training
- Conflicts of interest policy

Firms should implement the Guidelines in a way that is commensurate with the size and nature of their activities, including investment focus and strategies of their funds/mandates. The MAS expects managers' approaches to managing and disclosing environmental risk to mature as the methodologies for assessing, monitoring and reporting such risk evolve.

The **US** Department of Labor (DoL) said in March 2021 that it will not enforce a rule that makes it tougher for "401(k)" retirement plans to invest in ESG funds, by requiring plan fiduciaries to select investments and strategies based solely on how they will affect the plan's financial performance. *"We intend to conduct significantly more stakeholder outreach to determine how to craft rules that better recognize the important role that environmental, social, and governance integration can play in the evaluation and management of plan investments, while continuing to uphold fundamental fiduciary obligations,"* said Ali Khawar, principal deputy assistant secretary at the DoL's Employee Benefits Security Administration.

New laws under consideration would require investment advisers to maintain a sustainable investment policy, inform workers about it and to file it with the regulators. In April 2021, the SEC found some investment firms that are potentially misleading investors in their statements about their ESG investment processes and adherence to global ESG frameworks. It has also seen cases where portfolio managers were not consistently disclosing their ESG strategies and where their proxy voting on shareholder proposals did not align with the firm's stated stance on socially responsible issues.

Diversity – a social and regulatory issue

In **South Africa**, diversity has been a legal requirement for many years. For all jurisdictions, the recovery phase of the pandemic is likely to raise additional equality and potential discrimination issues, and some financial regulators are now focusing on this issue.

Official statistics are telling. Financial services were among **Europe**'s worst industries on gender pay gaps in 2018, according to Eurostat, and some asset managers are reporting deteriorating figures. Disclosure of diversity and inclusion (D&I) policies or reporting of pay information is mainly voluntary, but regulation has been introduced in a small and growing number of jurisdictions. There has been some progress within the investment industry on D&I policies. However, collecting data on the protected characteristics of a firm's workforce, including employees' ethnicity, has been one of the most common and difficult challenges faced by firms. Legal, data protection and trust issues can be obstacles to full disclosure.

Regulators are increasingly recognizing that good D&I practices reduce risk for regulated firms by reducing "groupthink". They are calling out pay gaps and lack of diversity among firms' boards and senior management, and prescriptive rules may be introduced if the industry does not make quick progress.

> ... good D&I practices reduce risk for regulated firms by reducing "groupthink"

For example, the **Japanese** Corporate Governance Code now includes a requirement for listed companies to disclose their approach, and set voluntary and measurable targets, for ensuring diversity in the appointment of core human resources, including the appointment of women, non-Japanese and mid-career hires to management positions. They must also disclose their human resource development policies and internal environment improvement policies to ensure diversity, along with the status of their implementation.

Back in 2018, the Central Bank of **Ireland** (CBI) warned that it would impose gender diversity requirements if improvements were not made. Sharon Donnery, Deputy Governor said gender balance can help ameliorate issues such as *"groupthink, insufficient challenge, poorly assessed risk and problems with culture"*, which, she said, contributed to the 2008 financial crisis. In March 2021, the CBI noted lack of progress in gender diversity at senior levels of regulated firms. This issue will continue to be a priority of the CBI, which will undertake detailed and thematic reviews.

The **UK** FCA has indicated that it expects to see sufficient diversity in a regulated firm's leadership team. D&I is a central consideration of the FCA in all aspects of conduct, including towards customers. In March 2021, FCA CEO, Nikhil Rathi said that diversity will be crucial in the FCA's consideration of vulnerability, particularly as we recover from a pandemic that has disproportionately affected women and people of color. The FCA will increasingly ask "tough" questions of firms about representation across grades, and whether their culture is open and inclusive and provides a safe space for colleagues at all levels.

The **European** Commission's five-year Gender Equality Strategy includes the introduction of binding measures on improving the gender balance on corporate boards. Such measures already exist in a few member states. In **France**, for example, the obligation for boards to have at least 40 percent female members was extended in January 2020 from listed companies to companies with at least 250 employees, and sanctions were strengthened.

To tackle gender and ethnic pay gaps, the Commission has issued a draft directive on equal pay for equal work, with transparency and enforcement provisions. Guidelines issued under the new Investment Firms Directive (see chapter 5) expect asset managers to apply a gender-neutral remuneration policy to all staff. The European Banking Authority, which is responsible for the guidelines, said that *"Any form of discrimination, based on gender or otherwise cannot be tolerated." It defines gender-neutral remuneration policies as being "consistent with the principle of equal pay for male, female and diverse workers for equal work or work of equal value"*.

Issues of pay inequality, the diversity and wellbeing of staff, career development and training, and links between remuneration and sustainability risks may be challenging for traditional remuneration committees. Firms will need to undertake a fundamental review of the terms of reference, skill sets and composition of their remuneration committees.

Key considerations for firms

- **Have we considered the range of regulations that will or may impact us, directly or indirectly? What is our roadmap for implementation and is it aligned with our overall ESG strategy and corporate reporting?**
- **What is our ESG governance structure? Have we identified key performance indicators? What is our process for monitoring and reporting on performance, and for reviewing our policies and processes?**
- **How are we embedding ESG considerations into our investment process, risk framework and product governance arrangements?**
- **What is our process for gathering and analyzing data on underlying assets and exposures?**
- **Are our disclosures and client communications clear and informative, and are we monitoring and responding to market trends?**
- **Do we have a clear Diversity & Inclusion policy and do we implement it effectively? Does our Remuneration Committee have the appropriate composition and skill sets?**

03. Regulating digital finance

The pandemic has been a technological catalyst. It has caused change on a greater scale and at a faster pace than any firm's planned ICT[1] strategy or any regulatory initiative. Initial lockdown measures to manage the pandemic caused years of change to take place in months, as firms moved to, and continue to operate, large-scale remote working.

The pandemic has also provided added impetus to governments' and regulators' plans to encourage moves towards digital finance and the widening use of technology. Regulators are attuned, though, to the risks of new technologies and increased digitalization, as well as the benefits.

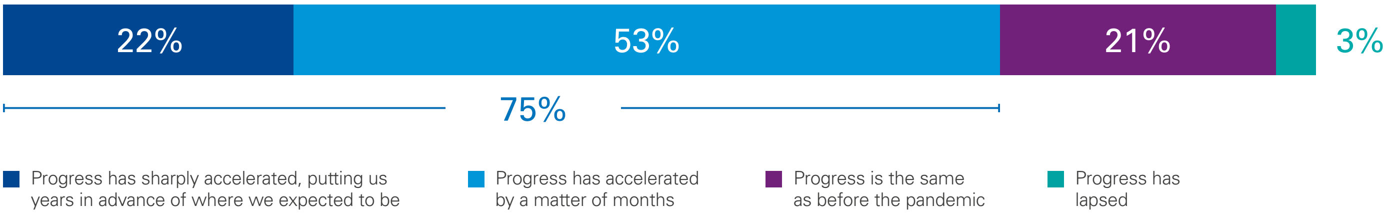
The **Malaysian** government's "Digital Economic Blueprint" outlines 22 strategies, to be implemented over 10 years to 2030, and is expected to attract new investments in the digital sector, from within and outside the country. The strategies include measures relating to Islamic finance, financial literacy and FinTech start-ups.

The **European** Commission has issued a wide-ranging package of measures, aiming to enable and support the potential of digital finance in innovation and competition, while mitigating the risks. The package comprises a Digital Finance Strategy, draft regulations on digital operational resilience (see chapter 5) and on markets in crypto-assets, and a pilot regime on market infrastructure based on distributed ledger technology (DLT). The long list of actions includes:

- Harmonized rules on customer onboarding
- An interoperable cross-border framework for digital identities
- An oversight framework for critical third-party ICT providers, such as cloud service providers
- Clarity on how financial services rules should apply to artificial intelligence applications
- An open finance framework
- Protections for digital finance customers.

1. Information and communications technology

Accelerated progress on digital customer experience



Source: *KPMG 2020 CEO Outlook COVID-19 Special Edition*

In January 2021, the **Luxembourg** parliament adopted a draft law that will modernize its law on dematerialized securities by expressly recognizing the possibility of using secure electronic registration mechanisms, including distributed ledgers, for the purpose of issuing dematerialized securities. **Germany** has passed a new law that legalizes the use of DLT in the securities sector. Previously, all securities issuers and holders have been required to record them on paper certificates. This will now be replaced by a simple entry in a central securities depository, which can be maintained by a bank. And **Brazil** has seen its first crypto-asset based deal in infrastructure.

A focus on customers

The trend in digitalization – doing more things in a digital way rather than on paper or face-to-face – has accelerated rapidly. There has been an increase in online investment tools, and communications are becoming more immediate. Online descriptions of services and products can be dynamic and customized, and therefore more engaging and educative. The use of internet platforms and social media has changed the way financial products are marketed and distributed, providing new opportunities for domestic and cross-border offerings.

The International Organization of Securities Commissions (IOSCO) is developing a set of policy measures to address and mitigate the risks posed by online cross-border marketing and distribution. The measures, expected by end-Q3 2021, will also contain guidance on effective enforcement approaches.

Moves to digital identity

The pandemic has accelerated trends in the digitalization of client onboarding. Given social distancing measures, firms increasingly turned to digital know-your-customer (KYC) checks to facilitate more remote customer onboarding approaches. The use of different forms of digital identity (ID) is spreading and policymakers' interest is increasing. Regulators are attuned to both its benefits and risks.

Digital ID facilitates mass data infrastructures, leverages scale and reduces operating costs. It is not perfect – verification issues can persist – but it can be underpinned by a robust KYC methodology. Use of digital ID has similar issues to traditional methods – identification, authentication and consent – but the issues manifest themselves in different ways. Access to quality and quantity of data is necessary for building robust authentication. Cross-border issues are significant and require global co-operation. A digital ID can include data about payments and transactions made by that person, but this raises additional data privacy concerns. It can help firms to identify and tackle financial crime, but if an ID is stolen, it could increase the opportunity for criminal activity.

Despite these challenges and risks, the appeal of digital ID is that it provides a more consistent and robust approach, departing from subjective processes. Potential funders of smaller capital-raising firms could use it to reduce the work required at the identification phase of onboarding. However, a digital ID requires co-operation between regulators and industry to maximize the benefits and mitigate the risks.

Some countries are already acting. **Singapore** has developed national digital ID infrastructure based on a trusted ID system that extracts data from a golden data source and provides a straightforward onboarding process, supporting people through their life cycle. **India** has brought 1.5 billion people onto a public data infrastructure and **Estonia** has introduced a DLT-based public digital ID system, alongside extensive online provision of state services. Culture is a key variable in rolling out such programs. Acceptance of the need to embrace digital ID requires customer trust in the form of the ID, understanding of how it will (and will not) be used, trust in the data attached to the ID and trust in the entity handling the data.

Data – a fundamental building block

Fundamental building blocks underpinning all technologies and digitalization are infrastructure and data. In chapter 5, we comment on the need for firms to ensure the integrity of databases, to have the expertise to store and analyze them, and to have in place good governance and controls. In this chapter, we consider the need both to protect customers' and market confidential data and to share them, to be able to deliver services more efficiently and across borders. **Switzerland** and **Austria** have adopted data standards, while other regulators are inclined to leave it to industry.

Governments, regulators and industry grapple with the legal issues around the transfer of customer data between entities and across borders, but in some jurisdictions the industry is being encouraged to embrace "Open Finance". Open Finance is the term used to describe data-sharing principles to enable third-party providers to access customers' data across a broader range of financial sectors and products, including savings and investments.

The exchange of both personal and non-personal data through (open) application programming interfaces can facilitate industry-wide innovation and increase the agility of businesses in responding to changes in customer needs and expectations. However, it could also give rise to new or amplified risks such as data security, cyber risks, interoperability challenges, and liability, ethical and broader consumer protection issues. Increased data sharing, especially if combined with artificial intelligence and machine learning (AI/ML) tools, could increase financial exclusion.

IOSCO investigates AI/ML

In its June 2020 consultation, IOSCO observed that ethical concerns may arise where the data that AI/ML models use are biased because data cleaning, transformation and anonymization were not adequately considered. The models may then behave in a biased way (for example, exhibit social biases) and potentially recommend undesirable outcomes. IOSCO's Fintech Network has warned firms to be careful when developing or deploying AI/ML tools that use large pools of alternative, non-traditional datasets, such as satellite data or twitter feeds. It has identified five primary themes that could underpin the ethical use of AI/ML techniques:

- Beneficence – "do good": ensure the model is being used or is acting in good faith, in the best interest of investors and with market integrity
- Non-malfeasance – "do no harm": be able to understand and interpret AI/ML-based decisions to identify where misconduct may be taking place
- Human autonomy, including auditability: ensure humans have power over what the model can and cannot decide
- Justice: ensure accountability at senior level for the actions of the model and understand the level of transparency needed to demonstrate justice
- "Explain-ability": ensure the outcomes arising out of the models can be explained

Firms can mitigate unintended ethical risks and challenges arising in the use of such tools by focusing on risk management over the electronic-to-electronic data cycle and on their culture, accountability, knowledge, expertise and operational resilience.

IOSCO is also working on appropriate regulatory frameworks for the supervision of asset managers and market intermediaries that utilize AI/ML. It has proposed six measures that reflect expected standards of conduct, which are equally applicable to any technology:

1. Governance and designated senior management responsibilities
2. Development, testing and ongoing monitoring of techniques
3. Adequate staff knowledge and skills (to develop, test, deploy, monitor and oversee controls, and so that compliance and risk management functions can understand and challenge algorithms, and conduct due diligence on any third-party provider)
4. Operational resilience (including managing relationships with third-party providers, monitoring their performance and conducting oversight)
5. Transparency and disclosure of the use of AI/ML
6. Appropriate systems and controls (to ensure that data are of sufficient quality and breadth to prevent biases)

Types of virtual assets

Crypto-assets – digital representation of value or rights which may be transferred and stored electronically, using DLT or similar technology.

Asset-referenced tokens, which purport to maintain a stable value by reference to fiat currencies or commodities and can be used as a means of payment (i.e. stablecoins).

E-money tokens, which can also be used as a means of payment, but their value is established by reference to only one fiat currency.

Regulating digital assets and DLT

Crypto-assets have been a focus of regulators around the globe for some time, with regulatory initiatives focused on the assets themselves, the trading of them or both. A debate has begun on whether the role of fund administrators regarding crypto-assets and digital currencies needs to be further articulated. The **Cayman Islands** government, for example, introduced the Virtual Asset (Service Providers) Act, 2020, which became effective in October 2020 and provides a framework for the regulation of the provision of virtual asset services. It is being rolled out in a phased approach, with the first phase involving the registration of entities providing virtual asset services.

The **European** Commission has published proposals to introduce a regulatory regime to regulate crypto-asset markets and to regulate the issuers of certain forms of asset backed crypto-assets, known as "stablecoins". The proposed regulation on markets in crypto-assets (MICA) aims to clarify the application of existing EU rules to crypto-assets and will introduce a new, harmonized legal framework for crypto-assets covered by existing rules. It defines three different types of virtual assets (see box).

The definition of financial instrument will be amended to clarify beyond legal doubt that such instruments can be issued via DLT. The Commission has also proposed a regulatory pilot that will provide a safe environment (a "sandbox" approach) and evidence for a possible permanent EU regulatory regime for DLT. The regulation limits the size of the issuance or trading of transferable securities on DLT market infrastructure and excludes sovereign bonds. Trading on DLT infrastructures will be subject to market abuse, data reporting and transparency rules.

The **Isle of Man** Financial Services Authority is considering the island's response to these proposals and how these changes may be reflected in its own regulatory perimeter. The **UK** government has sought views and evidence on the merits of regulating UK-based issuers of stablecoins. And the **Swiss** Financial Market Supervisory Authority (FINMA) has consulted on the application of DLT.

The government in **Hong Kong (SAR), China** has consulted on a new regulatory framework that will require centralized virtual asset exchanges to apply for a licence from the Securities and Futures Commission (SFC), whether they are operating in the jurisdiction or target Hong Kong investors. Licensees will be allowed to offer services to professional investors only. All virtual asset trading platforms will be regulated under either the existing opt-in framework introduced in 2019 or the proposed new licensing regime. Affected businesses will need carefully to consider the scope of permissible activities under the licence, what resources and experience they require, and whether they have adequate risk management and compliance procedures in place.

The Division of Examinations of the **US** Securities and Exchanges Commission (SEC) notes that various activities related to the offer, sale and trading of digital assets that are securities ("digital asset securities") present unique risks to investors. The Division encourages firms to consider the many distinct features of DLT when designing their regulatory compliance programs. The Risk Alert also provides observations made by Division staff during examinations of investment advisers, broker-dealers and transfer agents – which may assist firms in developing and enhancing their compliance practices – and indicates areas of focus for the Division's future examinations.

The European Securities and Markets Authority (ESMA) has again reminded **EU** consumers that some crypto-assets are highly risky and speculative and that they must be alert to the high risks of buying and/or holding these instruments, including the possibility of losing all their money. It also highlights that crypto-assets come in many forms but most remain unregulated in the EU. This means that consumers buying or holding these instruments do not benefit from the guarantees and safeguards associated with regulated financial services.

The **Spanish** Comisión Nacional del Mercado de Valores (CNMV) is expected to publish a Circular in 2021 on the marketing and publicity of crypto-assets. Meanwhile, it has clarified that UCITS[2] are able to invest in financial instruments with profit linked to cryptocurrencies not including an implicit derivative, provided the market price of the instrument is determined daily by a third party. Also, non-UCITS funds can invest directly, or via other funds, in cryptocurrencies. However, investors must be warned of the risks.

> "... growing use within investment funds"

Different approaches to access by retail investors

Supervisors are increasingly turning their attention to the ability of retail investors to access crypto-assets and their growing use within investment funds, but they are adopting different approaches. The **South African** Financial Sector Conduct Authority (FSCA) has expressed reservations and in **Canada**, although regulatory applications from investment funds that wish to hold crypto-assets and digital currencies have been successful, it is difficult to make them available to the public. On the other hand, the **Cyprus** Securities and Exchange Commission (CySEC) looks positively at crypto-funds, in line with a national strategy that favors regulating products, activities and uses of DLT, including crypto-assets. In October 2020, Cyprus saw the launch of its first actively-managed investment fund focused on the cryptocurrency markets.

Key messages for firms

- **New technologies bring new and emerging risks. Firms need to think innovatively about how to identify, measure and manage these risks, including the use of new techniques and tools.**
- **The ever-increasing dependence on good data heightens risks around quality, privacy, security, retention, ethics and sovereignty.**
- **Given the changing nature of products and services, of how they are delivered, and of communications with customers and counterparties, firms need to consider the end-customer, throughout the business and at all stages of a product lifecycle.**
- **Firms need to review their overall risk management framework and to attract staff with new skill sets, in a highly competitive market.**

2. Undertaking for collective investment in transferable securities

04. Reassessing investment and liquidity risks

Against the backdrop of ongoing uncertainty about the timing and shape of economic recovery, policymakers and securities regulators are reassessing the role of non-bank financial intermediation (NBFI). There is a focus on liquidity management in open-ended funds and asset valuations, with bond funds, money market funds (MMFs), exchange-traded funds (ETFs) and real estate funds all coming under increased scrutiny. Regulators are also determined to pursue issues that were already on their agendas, including a smooth transition to risk-free rates and access to market data.

The high volatility in capital markets in March 2020 was greater than during the 2008 crisis. Pinch points in the financial system contributed to a sudden demand for liquidity – "dash for cash" – which led central banks to intervene. Regulators recognize that the economic shock was caused by the pandemic, not by the financial services industry (unlike the 2008 crisis), and that its magnitude was such that the need for central bank interventions was unsurprising. There are concerns, though, about the precedents and incentives that the interventions may have set for the risk management of market participants, and about the potential for further market volatility and credit rating downgrades.

Remarkable resilience and recovery

The asset management and investment funds industry has remained broadly resilient despite the most extreme market conditions in living memory. However, a small number of open-ended funds had to suspend dealing temporarily during 2020, in the face of heavy redemption activity and difficulties in selling assets in volatile and sharply falling markets. Suspensions are of concern to both managers and regulators, given the impact on investors and potential risk of contagion effects in the wider market.

Flows into funds have returned. For example, the European Securities and Markets Authority (ESMA) noted that the **EU** fund industry continued to expand in the second half of 2020, reflecting strong flows and valuation effects. In particular, and in contrast to the significant outflows experienced during the market stress, bond funds recorded the highest inflows. And the size and composition of EU MMFs remained stable, with liquidity buffers plateaued at high levels, substantially above regulatory requirements.

Despite the industry's remarkable story of resilience and recovery, regulators are concerned that lessons should be learned, by both fund managers and supervisors. Moreover, asset managers and asset owners – especially the USD 6 trillion sovereign wealth fund sector – are being called upon by governments to help repair damage caused by the pandemic on national economies. This could lead to a shift in focus away from global investment strategies towards domestic investments. Coupled with lower levels of retirement and long-term savings, or increased drawdowns, due to income loss or uncertainty (see chapter 7), the investor universe could be reduced for some considerable time.

The industry is concerned that regulators should prioritize addressing the root causes that triggered the March 2020 stresses, such as the structure of bond markets, and only then consider necessary policy reforms for investment funds. As with all policy debates, there is the "test tube" problem. We can observe what happened with the current levels of asset management activity in capital markets and the current size and types of investment funds, but we cannot know for certain what would have happened if both had been different. If more private investors had held sovereign debt directly, not via investment funds, would there have been greater or lesser redemption activity? Might the regulatory disciplines around open-ended funds have helped to minimize or smooth asset redemptions, rather than exacerbate volatility?

The role of "non-banks"

The Financial Stability Board's (FSB's) November 2020 report to the G20 says that the interconnectedness within the NBFI sector and with banks, as well as greater reliance on market and funding liquidity to support market-based intermediation, reinforce the need to analyze the overall system. It notes that, *"Absent central bank intervention, it is highly likely that the stress in the financial system would have worsened significantly"* and that *"The financial system remains vulnerable to another liquidity strain, as the underlying structures and mechanisms that gave rise to the turmoil are still in place".*

> "regulators are concerned that lessons should be learned"

The report suggests that some parts of the NBFI sector acted as propagators of the liquidity stress during March 2020. It highlights liquidity mismatches, the build-up of leverage in certain types of investment funds, and that large differences arose between certain fixed income ETF share prices and the estimated value of their assets. It also observes that open-ended funds invested in illiquid assets could amplify liquidity stress, but recognizes that fund structures, underlying assets, and availability and use of liquidity management tools vary across different jurisdictions. The FSB's 2021/22 work programme includes:

- Proposals to enhance MMF resilience, including with respect to the underlying short-term funding markets
- Examination of the availability and effectiveness of liquidity risk management tools for open-ended funds, including the experience of redemption pressures and use of tools in the March 2020 turmoil and their aggregate impact on the market
- Consideration of how to improve the structure of core funding markets, including the role played by hedge funds and other leveraged investors
- Analysis of whether existing policy tools are sufficient for dealing with the systemic risks posed by non-banks and the desired level of resilience of NBFIs

The International Organization of Securities Commissions (IOSCO) is also working on these issues. In addition, IOSCO will report in mid-2021 on the findings of its thematic review of the impact of the growth of passive investing on equity capital markets. It will provide an overview of the increase in passive investing and its drivers; examine the impacts, if any, of increased passive investing on market efficiency and corporate governance; and investigate the consequences of the interplay between passive and other types of funds for how investors collectively pay for efficient and effective equity markets.

At her first meeting as chair of the Financial Stability Oversight Council in March 2021, **US** Treasury Secretary, Janet Yellen said she has asked for an interagency assessment of the vulnerabilities posed by open-ended mutual funds and for recommendations on whether the council should take additional action. During 2021, the Division of Examinations of the Securities and Exchanges Commission (SEC) will review:

- Preferential treatment of certain investors by advisers to private funds that have experienced issues with liquidity, including imposing gates or suspensions on fund withdrawals
- Portfolio valuations and the resulting impact on management fees
- Adequacy of disclosure and compliance with any regulatory requirements of cross trades, principal investments, or distressed sales
- Conflicts around liquidity, such as adviser-led fund restructurings, including stapled secondary transactions where new investors purchase the interests of existing investors while also agreeing to invest in a new fund

Liquidity management

In times of market stress, widely-held open-ended investment funds can encounter difficulties when redemptions suddenly increase, if underlying investments cannot easily be liquidated at prices close to valuations. MMFs and real estate funds were especially hit in certain markets during 2020, and there is ongoing concern about bond markets. Regulators are concerned about potential systemic risks arising from liquidity mismatches in funds and whether their access to and use of liquidity management tools has been effective. Many regulators had already reviewed their liquidity management requirements against IOSCO's 2018 recommendations but are revisiting the issue.

Luis de Guindos, Vice President of the **European** Central Bank (ECB) said in November 2020 that investment funds should hold more cash and liquid assets to ensure they can meet redemption requests in times of financial stress. He called for new rules to beef up funds' liquidity buffers and to ensure that redemption terms are closely aligned to the liquidity of the underlying assets. The ECB's long-held view that there should be a macroprudential framework for investment funds has been reinforced by the need for it to intervene in the euro money markets in early 2020. The Vice President said that existing safeguards, such as fund suspensions or "gating", had not been enough to stem outflows.

In the same month, ESMA warned investment funds with less liquid assets to prepare better for market shocks. Its report found shortcomings in the liquidity management of real estate and corporate debt funds during the period of high market volatility. Only 0.4 percent of the funds under review suspended during that period, but this figure was double the percentage for all EU funds. In comparison, many UCITS[1] in ESMA's sample used swing pricing to control or smooth redemption activity, where allowed by national rules, and only four suspended for up to 13 days due to valuation uncertainty and large outflows. The report contains analyses of which types of liquidity management tools are made available in each member state, with suspensions being the only commonly-available tool. ESMA set out five priority areas for fund managers and national regulators:

Liquidity management – focus areas

Focus area 1: Define the Framework and Policy for Liquidity Risk Management including your organization's tolerance appetite for liquidity risk.

Focus area 2: Assess and understand the liquidity profile of each fund; apply the right monitoring and measurement tools based on the fund's susceptibility to liquidity risk.

Focus area 3: Perform a liquidity risk assessment to identify the key factors that drive liquidity risk (both idiosyncratic and market-wide factors).

Focus area 4: Establish processes and procedures for liquidity monitoring and reporting, providing timely and accurate information to management team.

Focus area 5: Link the liquidity risk factors to the liquidity risk management framework and determine limits and tools for liquidity management monitoring.

Focus area 6: Implement specific, objective and realistic action plans that can be followed in case of breaches to established limits.

1. Ongoing supervision of the alignment of a fund's investment strategy, liquidity profile and redemption policy
2. Ongoing supervision of liquidity risk assessment, including consideration of the impact of margin calls and loan covenants in real estate funds
3. Fund liquidity profile reporting
4. Increase of the availability and use of liquidity risk management tools
5. Supervision of valuation processes in a context of valuation uncertainty

Guidelines on liquidity stress testing in EU funds came into effect in September 2020. In March 2021, ESMA issued the findings of a common supervisory action on UCITS liquidity risk management (LRM), in which all 30 EU/EEA national regulators participated. Overall, they reported that most

1. Undertaking for collective investment in transferable securities

UCITS managers demonstrated they have implemented and applied sufficiently sound LRM processes, but shortcomings were identified in a few cases:

— Poor quality and documentation of LRM arrangements, procedures and methodologies

— Over-reliance on liquidity presumptions about listed securities, and application of liquidity presumptions to financial instruments not admitted to or dealt in on a regulated market

— The entity to which the portfolio management function is delegated also effectively performs the LRM function

— Lack of data quality checks and over-reliance on very few data providers

— Disclosures missing, inaccurate or unclear

— Insufficient governance, weak internal controls framework, and external controls not performed by the depositary and external auditors

National regulators are acting. In **Sweden**, for example, the Financial Supervisory Authority has reviewed the need for additional liquidity management tools for open-ended funds. It has concluded that managers of UCITS and other retail securities funds should be able to use swing pricing, anti-dilution levies, redemption gates and notice periods. Also, UCITS should be allowed to redeem every two weeks. The regulator recommends that the conditions for using these tools should be regulated.

In September 2020, the **Spanish** Comisión Nacional del Mercado de Valores (CNMV) began to subject local investment funds to stress testing using a methodology it describes as "somewhat more precise" than that developed by ESMA. The government has approved a royal decree that gives the CNMV additional powers in the supervision of funds in response to the pandemic. CNMV is now able to grant notice periods for fund redemptions without fund managers having to specify the exact length of this period or the level of requested withdrawals. It is expected to publish in 2021 technical guidelines on liquidity management and controls.

The Bank of England and the **UK** Financial Conduct Authority (FCA) issued in March 2021 the findings of their joint survey of liquidity management in UK authorized, open-ended investment funds, covering the period Q4 2019 to Q2 2020. Respondents managed 272 funds investing in less liquid assets – corporate bond funds (including high-yield bond funds), mixed bond funds and a small number of small and medium cap equity funds. All funds were daily dealing, and none had a notice period in place. Net outflows in March 2020 were much larger for funds with predominantly institutional or intermediated investors than for those with direct retail investors. The authorities found that:

— Funds have a wide range of liquidity tools available to them (and used them more intensively during the stress period), but predominantly use swing pricing. However, tool selection and trigger points for their usage, and some pricing adjustment calculations, tended not to be fund-specific.

— Funds intensified and adapted their use of swing pricing during the stress period. There were large variations in how swing pricing was applied, which were not entirely explained by differences in primary strategies.

— Funds also held liquidity buffers in the form of cash and non-cash liquid assets, the two most common being units in MMFs and UK government bonds.

— Some funds adapted their liquidity management approaches and governance measures temporarily or permanently in response to the stress period.

— Managers of corporate bond funds may be overestimating the liquidity of their holdings, with some managers considering a large proportion of their holdings to be liquid in almost all market conditions, and most considering that the majority of their holdings have high valuation certainty.

MMFs and liquidity

A wide variety of investors – from non-financial corporations, public authorities and financial entities, to individuals – use MMFs as alternatives or complements to bank deposits. In some markets, MMFs tend to be institutional vehicles with large minimum subscriptions. In others, MMFs are used by retail savers.

According to the FSB's report (see above), at end-2019 MMFs accounted for approximately USD 7 trillion of assets under management. The FSB recognizes that the sector plays an important role in supporting the real economy, both as a liquid and diversified cash management tool for investors, and as a key source of funding for governments and financial and non-financial corporates. Also, the MMF sector is heterogeneous – with differing characteristics across jurisdictions, depending on fund type, structure and investor type – and that such differences are important in assessing the effect of pandemic-related market dislocations.

> "the sector plays an important role in supporting the real economy."

IOSCO's November 2020 report concurs that there is no common definition of MMFs. It observes that MMFs were severely tested in March and April 2020, when funds struggled to provide cash to investors rushing to redeem, while supplies of commercial paper were also drying up. Gaps exist in the accounting processes of EU-domiciled funds, making it difficult for funds accurately to conduct portfolio valuations, the report says. IOSCO suggests that funds offering a constant net asset value (CNAV) should be subject to measures designed to reduce the specific risks associated with a stable NAV and be forced to absorb the costs arising from those risks. Also, regulators should require CNAV funds to convert to variable NAV (VNAV) funds.

The **US** Securities and Exchanges Commission's (SEC's) December 2020 paper on experiences among US prime MMFs at the onset of the pandemic notes that, despite prior reform efforts to make MMFs more resilient to credit and liquidity stresses, investors redeemed USD 134 billion from prime and tax-exempt MMFs in March 2020, while government MMFs took in USD 838 billion. Although the overall MMF industry grew during this period, the large outflows from prime MMFs highlighted the remaining structural vulnerabilities in these funds, says the report.

The SEC consulted until April 2021 on possible regulatory reforms:

- Removal of the tie between MMF liquidity and fee and gate thresholds
- Reform of conditions for imposing redemption gates to reduce their likelihood
- Imposing a minimum balance at risk that investors can redeem only with a time delay
- Liquidity management changes
- Countercyclical weekly liquid asset requirements
- Floating NAVs for all prime and tax-exempt MMFs
- Swing pricing requirement
- Capital buffer requirements
- Mandatory liquidity exchange bank membership
- New requirements governing sponsor support

ESMA issued updated guidelines on stress test scenarios for **EU** MMFs in December 2020 to reflect experiences in 2020. It is now seeking views by end-June 2021 on the EU Money Market Fund Regulation, to inform the review that the Commission must undertake by July 2022. The Regulation provides for three main types of MMFs: public debt CNAVs, low volatility NAV funds (LVNAVs) and VNAVs, which represent 7 percent, 48 percent and 45 percent of EU MMFs, respectively. ESMA notes that MMFs remain subject to a range of vulnerabilities, including liquidity of underlying markets, regulatory requirements and the role of credit rating agencies.

It is considering reforms in three broad areas, not all of which may apply equally to the three types of funds:

- On the liability side (e.g. swing pricing, redemptions in kind, holdbacks, minimum balance at risk, or removal of CNAVs)
- On the asset side (e.g. restrictions on asset holdings, increased liquidity buffers and/or making them usable/countercyclical, decoupling regulatory thresholds from suspensions/gates)
- External to MMFs themselves (e.g. related sponsor support, enhance liquidity of underlying instruments in which MMFs invest, a liquidity exchange bank, enhanced MMF reporting to and stress testing by authorities)

ETFs – a growing market

At end-2020, assets under management in ETFs stood at around USD 8 billion, having doubled over the previous four years. Also, ETFs are being launched in an increasing number of jurisdictions. For example, 2020 saw the launch of new ETFs by fund managers in **Saudi Arabia**. The concept of ETFs is not new to the Kingdom, but fund managers are expanding their horizons in terms of the underlying assets in an ETF. Where predominantly the underlying securities used to be equities, there is now diversification towards sukuk and commodities, to cater for evolving market conditions and investor demand. There is also a growing interest in ETFs in **Qatar**, where banks are considering launching new funds.

As noted above, the FSB is concerned about differences between ETF share prices and estimated values of underlying assets. The 2021 priorities of the **US** SEC's Division of Examinations include reviews of ETFs and their managers. It is collecting publicly-disclosed data on trade quality, such as spreads, and private information about how the funds are being operated. The funds are required to monitor creation and redemption activity and trading activity on the exchange. The Division is reviewing compliance with exemptive reliefs provided against these obligations, including for the newly created non-transparent, actively-managed ETFs.

Fair value

In times of market stress, otherwise automated asset valuation processes can require manual intervention, and sudden changes in asset valuations can lead to "passive" breaches to exposure limits. Several regulators are therefore reviewing the industry's valuation processes.

For example, in December 2020, the **US** SEC adopted a final rule that establishes a new framework for fund valuation. The rule lays out a process for how companies comply with requirements related to accounting, auditing and overseeing how value determinations are made. Major provisions in the rule include terms for how the fund's board of directors is involved in the valuation process and allowances for it to designate and oversee parties performing fair value determinations.

The Division of Examinations will review filings and reports to funds' boards for compliance with regulatory requirements and for valuation issues. In focusing on valuation and the resulting impact on fund performance, liquidity and risk-related disclosures, the Division will review for investments in market sectors that experienced, or continue to experience, stress due to the pandemic, such as energy, real estate, or products such as bank loans and high-yield corporate and municipal bonds. The Division will also review funds' and advisers' disclosures and practices related to securities lending.

Derivatives and leverage

Highly-leveraged funds are another focus area for policymakers. Sir Jon Cuncliffe, Bank of England commented on funds that undertake arbitrage trades on the price differences between the value of derivatives and the value of the cash instrument upon which the derivative is based. In "normal" market conditions, these trades are generally viewed as stabilizing market prices. However, various pressures meant that these funds had to undertake massive sales of government bonds (almost USD 90 billion during March 2020), causing further falls in bond prices.

The important function that derivatives can play is recognized by other regulators. The Saudi stock market launched an index futures product in 2020, which will allow investors to gain index exposure to Saudi equities included in the MSCI[2] index. This marked the beginning of an exchange-traded derivatives market in **Saudi Arabia** and presents opportunities for fund managers to supplement and diversify portfolios.

In October 2020, the **US** SEC adopted a new rule to enhance the regulatory framework for derivatives use by registered investment companies, including mutual funds (other than MMFs), ETFs and closed-end funds. Then SEC Chair, Jay Clayton said, *"Today's action provides for a comprehensive framework for funds' derivatives use that provides both meaningful protections for investors and regulatory certainty for funds and their advisers".* Funds can now enter into a range of derivative transactions, provided they comply with certain conditions designed to protect investors and make additional filings. The conditions include adopting a derivatives risk management program and complying with a limit on the amount of leverage-related risk that the fund may obtain based on value at risk. A streamlined set of requirements apply for funds that use derivatives in a limited way.

Real estate funds

In its third annual report on **EU** alternative investment funds (AIFs), ESMA aired concerns over real estate funds and funds of funds regarding the mismatch between the potential liquidity of the assets and the redemption time frame offered to investors. Some member states require real estate funds to be closed-ended, but in aggregate just over half of EU real estate funds are open-ended, and 44 percent of commercial real estate funds, which are the largest category, offer daily liquidity to investors. The **French** Autorité des Marchés Financiers (AMF) is also concerned about the valuation and liquidity of real estate funds. Given current fears about the resilience of commercial property, the AMF will analyze the liquidity risk management systems of real estate fund managers.

There are about 20 **UK** retail funds described as property funds and that offer daily dealing, some of which are long-standing and have navigated various market crises. All funds invested in inherently illiquid assets have been subject to additional requirements since 2019, which include increased depositary oversight, standard risk warnings on financial promotions, increased disclosure of liquidity management tools and mandatory liquidity risk contingency planning. The FCA proposed in August 2020 that funds investing predominantly (more than 50 percent) in property, and that offer more frequent than monthly redemptions, should be subject to an additional notice period requirement:

- Each investor's redemption request would be received and recorded, then processed at the end of a notice period
- The investor would receive the value of their investment, based on the unit price of the fund at the first valuation point following the end of their notice period

Moving to RFRs

Initial impact assessment
Modelling and systems analysis by all business units of: operational, legal and conduct risks; functional, economic and client impacts; and regional timings.

Strategic Planning
Based on economic impacts to existing portfolios and potential business opportunities: establish client communication and negotiation workflows; review contract structure; and evaluate profitability, cash-flows and hedging risk.

Governance & client outreach
Develop internal governance processes to approve changes to policies, systems, processes and controls; educate client-facing staff to guide clients transparently and fairly through the process.

Contract identification
Leveraging technology if possible, identify all products and business lines, including expected fall-backs, and the bilateral negotiations likely to be in scope.

IBOR exposures & risk management
Measure exposure by maturities beyond 2021, grouped by fund, portfolio and counterparty.

2. Morgan Stanley Capital International

— Redemption requests would be irrevocable, so investors could not place orders and withdraw them before the end of the notice period if market conditions change (to avoid the fund manager selling property to meet redemption requests that are subsequently cancelled)

No restriction will be imposed on daily subscriptions, the risk warning will no longer apply and there might be a reduced need for liquidity risk contingency planning. In May 2021, the FCA announced that it was deferring a decision on new rules while it is consulting on long-term asset funds (see chapter 8).

The Central Bank of **Ireland** is reviewing the risks associated with investment funds investing in Irish property assets, specifically liquidity mismatch and leverage, which could result in funds needing to sell property assets over a relatively short period of time, amplifying price pressures in the commercial real estate market. Sharon Donnery, CBI Deputy Governor said *"The growth of Irish property funds since the global financial crisis has brought with it many benefits, including the diversification of financing channels for commercial real estate away from domestic investors towards international investors."* She added, however, that given the growth of Irish property funds in recent years, the resilience of this form of financial intermediation matters more today than it did a decade ago. The CBI is considering leverage limits and options to limit liquidity mismatches.

Transition to risk-free rates nears

Another imminent risk to capital markets stability is the likely demise of the widely-used London inter-bank offer rate (LIBOR) at the end of 2021 and the challenge of transitioning to risk-free rates (RFRs). The FSB's roadmap includes a smooth transition away from LIBOR to more robust benchmarks. The pressure is on firms to implement transition plans, as the **UK** FCA has confirmed that LIBOR will end in its present form for all currencies apart from USD at the end of 2021.

The **US** SEC has noted that the discontinuation of LIBOR could have a significant impact on the financial markets and may present a material risk for certain market participants, including registered investment advisers, broker-dealers, investment companies, municipal advisors, transfer agents and clearing agencies. Preparation for the transition away from LIBOR is essential for minimizing any potential adverse effects associated with LIBOR discontinuation

Market data: cost and access

IOSCO consulted until end-February 2021 on the cost of and access to market data, and the need for consolidated market data. Several jurisdictions, including **Australia**, the **EU** and the **US**, are contemplating whether regulatory changes are necessary. IOSCO intends that the findings of its consultation will provide useful information for jurisdictions considering their supervisory and regulatory approach.

Also, by end-2021, IOSCO will report on the findings of its thematic review of conduct-related issues in relation to index providers. The review will explore issues related to the role of asset managers in relation to indices and index providers, and the role and processes of index providers in the provision of indices (including the potential impact of administrative errors on funds and identifying potential conflicts of interest that may exist at index providers in relation to funds).

European authorities are seeking to improve reporting standards, with harmonization, effectiveness and efficiency being strong themes. The new reporting requirements under the **EU** Securities Financing and Transaction Regulation (SFTR) commenced in October 2020 for investment funds and some in-scope third-country entities, and in January 2021 for non-financial counterparties. As part of the review of the Markets in Financial Instruments Regulation (MiFIR), ESMA has consulted on the transparency regime and the reference data and transaction reporting obligations. The objective is to simplify the current reporting regimes and enhance the quality of reported data, by ensuring consistency among various reporting and transparency requirements. Also, changes introduced to MiFIR by the new Investment Firms Regulation (see chapter 5) will require annual reporting to ESMA by third-country firms providing investment services into the EU.

Key considerations for firms

— **Fund managers should review all aspects of their liquidity risk management for open-ended funds, including whether they use liquidity management tools in an appropriately calibrated manner for each fund, and whether their disclosures to investors are clear.**

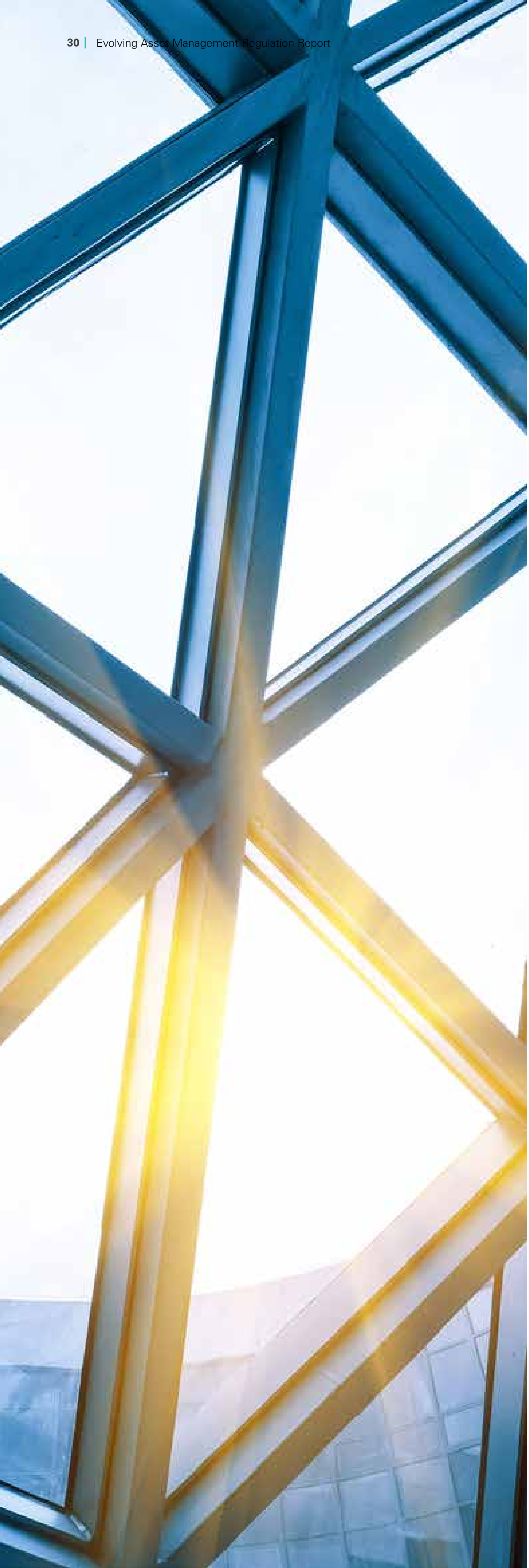
— **Fund managers will need to evidence that they have critically analyzed experience during the 2020 market stress, and that their policies, processes, controls and documentation meet supervisory expectations.**

— **Firms should review how their asset valuation processes work during periods of market stress and be able to evidence the pursuit of fair value, to regulators and investors.**

— **Firms should review their risk management processes for derivatives, their use of leverage, and client disclosures.**

— **Managers of open-ended funds invested in private and real assets should consider whether the funds' redemption policies are appropriate for the illiquidity of the underlying assets and whether disclosures to investors are clear.**

— **Firms should be progressing plans to transition to RFRs.**



05. Redefining firms' resilience

Regulators have long expected firms to manage operational risks and have in place business continuity and disaster recovery plans. In the new post-pandemic reality, operational resilience is viewed as more than this. When identifying potential disruptions to business, firms need to consider not if, but when.

Additional demands on systems and processes arising from prolonged and large-scale remote working, and an increasingly digital world, has increased the focus on firms' technological resilience. Outsourcing to third parties, cybersecurity and money laundering risks are not new, but regulatory focus is turning to the broader ICT[1] risk environment. And some jurisdictions are introducing new capital requirements for investment managers, with the aim of better defining minimum financial resilience.

Operational resilience

Regulators are acutely aware that the threat of disruption to firms, and by extension to their customers, is heightened in times of stress. Technology-led business transformation, high-profile instances of disruption and recognition of the interconnectedness of the financial system have led to increased attention on operations and how things are done. Operational resilience is seen as the outcome of effective management of operational risk and is becoming a key driver of investment and business strategy. Regulators around the globe are focused on common themes:

- Greater accountability and ownership, with engagement from the top down
- Clear definition of a firm's key business activities
- Understanding the key dependencies required to deliver those activities
- Testing resilience under stress scenarios
- Defining meaningful metrics to quantify resilience and assess tolerances for disruption
- Ensuring timely and appropriate communications for investors

In June 2020, in response to the pandemic, the Monetary Authority of **Singapore** (MAS) issued guidance to address operational, technology and cyber risks. In March 2021, this was expanded by a paper on "Risk Management and Operational Resilience in a Remote Working Environment", which highlighted possible risks to financial institutions in the areas of operations, technology and information security, fraud and staff misconduct, and legal and regulatory risks. It also examines the impact of remote working on people and a firm's culture.

A broader approach to operational resilience – incorporating equally important components such as processes and people – is increasingly expected of firms. Regulators are highlighting the importance of identifying severe but plausible tailored scenarios, and of performing stress tests to reveal weaknesses in operating models. Firms need to consider not only what would happen *if* they were to experience disruption, but how they will respond *when* it happens. This requires firms to define the amount of disruption they would be willing to tolerate, to create metrics to monitor and measure their ability to remain within these tolerances, and to test for various scenarios against them.

The **UK** Financial Conduct Authority (FCA) has set out its new approach to operational resilience for investment managers with a three-year rolling average of GBP 50 billion or more assets under management. The policy aims to ensure that firms plan appropriately and deliver improvements to their operational resilience so that they can respond effectively to disruptions (including multiple concurrent disruptions) to their most important business services – those with the greatest potential to cause financial instability or customer detriment. Best practice will develop over time, but firms are encouraged to view the policy as a minimum standard and to develop an approach that is proportionate to their size, scale, and complexity.

A three-year implementation period will start on 31 March 2022, by when firms will be expected to have identified and mapped their important business services, defined impact tolerances, and commenced a program of scenario testing. They should also have a prioritized plan setting out how they intend to comply with the requirements. Outsourcing arrangements entered into on or after 31 March 2021 should meet supervisory expectations by end-March 2022, and earlier agreements should be reviewed at the first appropriate contractual renewal or revision point.

The Central Bank of **Ireland** (CBI) is consulting until July 2021 on cross-sector guidance on operational resilience, which takes into account the EU proposals on digital operational resilience (see below). The draft guidance will require all regulated firms to review existing agreements with third-party service providers (and with those providers' service providers) to ensure they have *"at least equivalent operational resilience"* conditions in the event of another crisis. Firms will have to identify impact tolerances, carry out scenario testing and ensure that legally-binding written agreements are in place with third parties that detail how the critical or important services will be maintained during a disruption, including down the supply chain. In some instances, this could result in firms appointing new third-party service providers or taking the services in-house. For firms that rely on many third parties for the delivery of critical or important business services, there could be a greater cost impact if most of or all their service providers have to revise upwards their operational resilience conditions.

Operational resilience – a regulatory imperative

1. Information and communications technology

Data resilience

Regulators are attuned to data risks, as part of operational resilience. Firms need to ensure the integrity of exponentially expanding databases and that they have the expertise to store and analyze them, whether in-house or via outsourcing to third parties. They need both to protect customers' and market confidential data and to share them, to deliver services more efficiently and across borders. Effective controls are essential around internal processes, the storage and use of data, communications with customers and counterparties, and contractual arrangements with third parties.

The growth in available data requires expanded storage infrastructure and more efficient search and indexing protocols. One solution to address the rising cost of data storage is to make more use of cloud technology, but this has both advantages and challenges. Cloud service providers can offer geographically dispersed infrastructure and heavy investment in security, providing firms increased resilience and allowing them to scale more quickly and operate more flexibly. However, firms can encounter operational, governance and oversight issues (particularly in a cross-border context), provider concentration risk and increased cyber vulnerability.

Outsourcing

In May 2020, the International Organization of Securities Commissions (IOSCO) consulted on new and expanded principles on outsourcing, noting that *"operational resilience refers to the ability of regulated entities, other firms such as service providers, and the financial market as a whole to prevent, respond to, recover, and learn from operational disruptions."* The revised principles comprise a set of fundamental precepts and a set of seven principles. The fundamental precepts cover issues such as the definition of outsourcing, assessment of materiality and criticality, application to affiliates, treatment of sub-contracting and outsourcing on a cross-border basis. The final principles are awaited.

The European Securities and Markets Authority's (ESMA's) guidelines on outsourcing to cloud service providers will apply from July 2021 and **EU** firms should review their existing outsourcing arrangements against the new guidelines by end-2022. Firms must put in place a specific strategy for any cloud outsourcing services, including appropriate governance arrangements and more stringent cyber security measures. Pre-outsourcing analysis and due diligence should be undertaken before appointing a provider and contracts must typically include specific terms regarding access and audit rights and subcontracting. Exit strategies (including planning and testing how a firm would migrate to another provider) should be considered before appointing a provider. An updated outsourcing register must be maintained and shared with regulators as requested.

IOSCO draft Principles on Outsourcing

Principle 1: Suitable due diligence processes in selecting an appropriate service provider and in monitoring its ongoing performance.

Principle 2: A legally binding written contract with each service provider, the nature and detail of which should be appropriate to the materiality or criticality of the outsourced task to the business of the regulated entity.

Principle 3: Appropriate steps to ensure the firm and its service providers establish procedures and controls to protect the regulated entity's proprietary and client-related information and software, and to ensure a continuity of service to the regulated entity, including a plan for disaster recovery with periodic testing of backup facilities.

Principle 4: Appropriate steps to ensure that service providers protect confidential information and data related to the regulated entity and its clients, from intentional or inadvertent unauthorized disclosure to third parties.

Principle 5: Awareness of the risks posed, and effective management of them, where the firm is dependent on a single service provider for material or critical outsourced tasks, or where it is aware that one service provider provides material or critical outsourcing services to multiple other regulated entities.

Principle 6: Appropriate steps to ensure that the firm, its regulator and its auditors are able to obtain promptly, upon request, information concerning outsourced tasks that is relevant to contractual compliance and/or regulatory oversight, including access to the data, IT systems, premises and personnel of service providers, relating to the outsourced tasks.

Principle 7: Written provisions in contracts with service providers relating to the termination of outsourced tasks and appropriate exit strategies maintained.

The guidelines around governance, oversight and documentation may be challenging for smaller IT departments. The need to complete a very specific cloud strategy may be outside the capability of some firms, which will need to seek external guidance. Also, the contractual rights required by IOSCO's principles, ESMA's guidelines and other regulatory requirements could be challenging for firms to negotiate and exercise, particularly in a multi-jurisdictional context. As part of its FinTech Action Plan, the European Commission intends to prescribe standard contractual clauses for such outsourcing agreements.

The Central Bank of **Ireland** is consulting until end-July 2021 on cross-sectoral outsourcing guidance that reaffirms its adoption of relevant European Supervisory Authorities' guidelines on outsourcing to cloud service providers. The draft guidance should be read in conjunction with the draft guidance on operational resilience (see page 31). It includes the role of the board and senior management in outsourcing, linkages to operational resilience, expectations on intragroup arrangements and assessment of concentration risk. It emphasizes digital risks and outlines information to be provided to the CBI in relation to outsourcing (notification of critical or important outsourcing, adverse incidents and periodic outsourcing register returns).

Meanwhile, as part of the implementation of the new Financial Institutions Act, the **Swiss** Financial Market Supervisory Authority (FINMA) has extended the scope of its outsourcing requirements, originally designed for banks and insurers, to selected financial institutions – fund management companies, managers of collective assets and self-managed investment companies with variable capital (SICAVs). A key point of debate is what constitutes a "significant function," the delegation of which is an outsourcing, according to the circular.

Cyber security

Cyber resilience has long been viewed as the backbone of operational resilience programs and continues to be of critical importance. Cyber criminals are developing a growing understanding of business flows within the investment industry. They are adopting ever-more sophisticated approaches, such as attempts to hijack fund login credentials or to retrieve confidential data.

The Financial Stability Board's (FSB's) final report on effective practices for cyber incident response and recovery sets out a toolkit of 49 practices across seven components: governance, planning and preparation, analysis, mitigation, restoration and recovery, co-ordination and communication, and improvement. The FSB is now exploring the scope for convergence in the regulatory reporting of cyber incidents. The **European** Commission's new cybersecurity strategy includes overhauling existing rules for critical sectors. Firms will need to pay closer attention to the cybersecurity of their software and hardware suppliers: supply chain security.

The **French** Autorité des Marchés Financiers (AMF) has observed an increase in the volume and sophistication of cyber-attacks, following inspections of asset managers' cyber-security systems. It examined the systems and processes put in place by six firms to address the risk of malicious attacks on the availability, integrity, confidentiality and traceability of their information systems. The AMF notes that cyber-security risks are increasingly well factored into firms' governance and control systems, but *"this has been achieved without sufficient prior research on the main risk areas to be protected, which helps maintain a false impression of security among the players inspected".*

The AMF cites good practices such as the appointment of a dedicated manager from the executive committee to handle cyber security topics, the implementation of regular awareness-raising campaigns for employees, and the inclusion of cyber risks into risk mapping and control plans. Faced with the raising volume and sophistication of cyber-attacks, the management and control of interactions between asset managers and their external ICT service providers *"must remain a priority when defining security measures".*

The Division of Examinations of the **US** Securities and Exchanges Commission (SEC) is working with firms to identify and address information security risks, including cyber-attack related risks, and is encouraging market participants actively and effectively to engage regulators and law enforcement in this effort.

ICT risk – taking a broader view

The regulatory focus on cyber security is evolving into consideration of the broader ICT risk environment: "digital operational resilience". Regulators are emphasizing that increased use of technology requires firms to revisit their governance arrangements and controls to ensure they have the right level of expertise and understanding at senior management levels in order to govern well and to identify emerging and heightened risks. Use of artificial intelligence and machine learning are attracting special regulatory attention in this regard, as outlined in chapter 3.

Equally, technology can help firms to govern their businesses, manage risks and improve customer outcomes. Firms are using technological applications – RegTech – to ensure they have a full understanding of the rules to which they are subject and to check or validate their compliance with those requirements. Technological applications can challenge traditional governance arrangements and controls and increase the divide between the tech savvy and technophobes. The positions of Chief Technology Officer and Chief Data or Information Officer, in addition to Chief Operating Officer, are being created, in part to help bridge this divide at senior management level.

Digital operational resilience

The ability of a financial entity to build, assure and review its operational integrity from a technological perspective by ensuring, either directly or indirectly, through the use of services of ICT third-party providers, the full range of ICT-related capabilities needed to address the security of the network and information systems, which a financial entity makes use of, and which support the continued provision of financial services and their quality.

The **European** Commission has published a wide-ranging draft regulation on digital operational resilience for the financial sector (DORA). DORA will establish a comprehensive EU framework with rules for all regulated financial institutions, with only minor concessions to proportionality. It will:

1. Streamline and upgrade existing financial legislation (including fund and asset management rules), by:
   - Better aligning firms' business strategies and the conduct of ICT risk management, to improve overall management of ICT risks, and ensure firms can assess the effectiveness of their preventive and resilience measures and identify ICT vulnerabilities
   - Applying testing requirements proportionate to a firm's size, business and risk profile
   - Strengthening firms' oversight and ensuring sound monitoring of third-party ICT
   - Raising awareness of ICT risk and minimizing its spread through information-sharing, including allowing firms to exchange cyber threat information and intelligence
2. Create more coherent and consistent incident reporting mechanisms, to reduce administrative burdens for firms and strengthen supervisory efficiency, by:
   - Harmonizing and streamlining the reporting of ICT-related incidents
   - Increasing supervisors' knowledge of threats and incidents by enabling them to access relevant information

Proposals for ICT risk management, including the management of third-party risk, will be complex to implement and the reporting of major incidents and enforcement processes requires further clarification. Detailed rules and guidance yet to be issued may provide some clarity but are unlikely to mitigate all the challenges.

Prevention of money laundering

New provisions in **Saudi Arabia** around anti-money laundering (AML) and systems and policies will require fund managers to upscale their systems, controls and processes in order to comply with the regulations and enable enhanced risk assessments and mitigations. New AML requirements are also in force in **Canada**, covering due diligence, record keeping and identity checks.

The Division of Examinations of the **US** SEC continues to prioritize examinations of broker-dealers and registered investment companies for compliance with their AML obligations and whether firms have adequate policies and procedures in place that are reasonably designed to identify suspicious activity and illegal money-laundering activities. The SEC is assessing whether firms have established appropriate customer identification programs and whether they are satisfying their filing obligations, conducting due diligence on customers, complying with beneficial ownership requirements, and conducting robust and timely independent tests of their AML programs.

The CBI has issued a Dear CEO Letter, reminding **Irish** "Schedule 2" firms of their obligations and outlining the findings of its 2020 review. Failings related to board oversight and governance, risk assessments, policies and procedures, customer due diligence, adherence to sanctions, suspicious transaction reporting and staff training. The European Commission is expected soon to issue a proposal for a stand-alone **EU** AML agency that would have supervisory powers over financial and some non-financial companies.

Re-calibrating financial resilience

The capital requirements for **EU** and **UK** investment managers are changing. They will no longer be subject to rules that were predominantly designed for banks. The EU Investment Firms Directive and Regulation are due to come into effect in June 2021, and the UK rules, which are broadly aligned with the EU rules, will apply from January 2022. Both will introduce simplifications to current rules, but all firms will need to re-assess their capital requirements and change their reporting systems.

Investment managers will fall into two broad categories: "small and non-interconnected" (SNI) or not. A firm's minimum capital requirement will be based on three measures:

- The "permanent minimum capital requirement" (PMR) will be EUR/GBP 75,000 for investment managers that do not hold client assets and EUR/GBP 150,000 for those that do
- The fixed overheads requirement (FOR) – one quarter of the previous year's fixed overheads
- The "K-factors" requirement, which is essentially a mixture of activity- and exposure-based measures

The capital requirement for SNIs will be the higher of their PMR and FOR. Non-SNIs will need to have capital that is the higher of their PMR, FOR and K-factors. In January 2021 the CBI outlined its expectations on how **Irish** firms should be preparing for the new prudential regime, *"Firms should complete a comprehensive analysis of all relevant aspects of the IFR/IFD and identify how it will impact the respective firm's business model."*

Key considerations for firms

- **Is operational resilience viewed as a business priority and integral to our business strategy? Do we have a robust communication strategy for use with customers and other key stakeholders?**
- **Have we assigned clear responsibilities for operational resilience (including IT), and do we have effective Board engagement and an appropriate supporting governance structure?**
- **Have we clearly identified and documented our key/critical/important business services from the perspectives of our own firm, and potential impacts on customers and the wider financial system?**
- **Are we ensuring the integrity of our databases, the appropriate use of data, and good controls around third-party data suppliers and data storage providers?**
- **Are we confident that our third-party relationships are well-managed and that the contracts we have in place support resilient responses? How do we gain assurance around this, and where contracts fall short, what actions can/will we take?**
- **Are we up-to-speed with the increasing sophistication of cyber-attacks and do we have the best systems in place to identify, prevent and recover from incidents?**
- **Are we using technology effectively to improve our governance, systems and controls, to run our businesses more efficiently, and in our communications with regulators?**

06. Reinforcing good governance

Supervisors are once again reinforcing the need for good governance of firms, including board composition and engagement, clear responsibilities and individual accountability. Extended remote working is challenging existing systems and controls. Product governance is under the spotlight, together with firms' behavior in the capital markets and stewardship of client assets.

The trends towards sustainable investment strategies, alternative asset classes and digitalization bring with them added complexity to business models and challenges to existing operational processes. Firms will find that regulators require them to do more in terms of governance structures, procedures, and onboarding of highly-skilled professionals in core functions and among board directors.

Governance arrangements and accountability

The composition of boards of directors is under the spotlight, and whether fund management companies (FMCs) appropriately challenge asset managers to which they have delegated portfolio management of their funds. For example, according to the findings of the Central Bank of **Ireland** (CBI) issued in October 2020, some Irish FMCs lacked sufficient substance and were not challenging investment managers effectively.

The CBI reviewed compliance with its framework on FMC governance and oversight. Newer FMCs were generally in compliance, but FMCs that have been active in Ireland for some time were found not to have sufficient substance to deal with their regulatory requirements and had not fully implemented the rules. This included having an insufficient number of full-time employees and a lack of staff of sufficient seniority and experience, relying instead on group resources. The CBI requires FMCs to have at least the EU minimum of three full-time employees for the smallest and simplest of entities, with the number rising in proportion to the complexity of the operation.

The CBI also found that nearly 30 percent of FMCs had an independent director who had been on the board for more than 10 years, which called into question their independence and that fund boards are not sufficiently challenging the appointed investment manager, including not conducting appropriate due diligence or receiving delegate reports of insufficient quality to allow for meaningful review. There were instances of poor documentation and recordkeeping.

All FMCs received a letter from the CBI requiring them to undertake a review of compliance by end-March 2021, and some were subjected to special supervisory measures by the regulator. The review was not a one-off – assessment of FMCs' compliance will form part of the CBI's ongoing supervisory engagement. The regulator has also found weaknesses in regulated financial service providers' compliance with fitness and probity rules. Inspections found that awareness of the obligations among boards was poor, due diligence for board and senior management appointments was weak, and there were not processes in place for robust testing of fitness and probity to identify and escalate concerns.

The **UK** Financial Conduct Authority (FCA) is concerned about overlapping directorships between an FMC and its delegated asset manager, especially among smaller and medium-sized companies, which it regards as an inherent conflict of interest. In September 2020, Marc Teasdale, FCA Director of Wholesale Supervision said the regulator often saw insufficient consideration being given to the conflicts of interest caused by heavily overlapping boards. Among other things, in its value assessment for each fund, an FMC's board needs to avoid the risk of bias in favor of the company's overarching commercial interests. Directors can continue to hold multiple directorships but must be able to demonstrate to the FCA that they have identified and declared, and are managing or preventing, any conflicts of interest.

In the same month, the Monetary Authority of **Singapore** (MAS) published guidelines and good practices, to strengthen the accountability of senior managers in key functions in financial institutions and to promote ethical behavior. The MAS set out five high-level outcomes it expects of firms (see box).

In November 2020, the **US** Securities and Exchanges Commission (SEC) warned registered investment advisers of compliance shortcomings with securities regulations and for not empowering chief compliance officers (CCOs). The Division of Examinations found deficiencies related to the compliance rule, which requires firms to develop policies and procedures that ensure they meet their fiduciary and regulatory obligations. Notable issues included inadequacies in compliance resources and training, authority of the CCO within the firm, annual reviews, written policies and procedures, and implementing actions required by policies and procedures.

Good governance outcomes

1. Senior managers responsible for managing and conducting the firm's core functions are clearly identified
2. Senior managers are fit and proper for their roles, and held responsible for the actions of their employees and the conduct of the business under their purview
3. The firm's governance framework supports senior managers' performance of their roles and responsibilities, with a clear and transparent management structure and reporting relationships
4. Material risk personnel are fit and proper for their roles, and are subject to effective risk governance, and appropriate incentive structures and standards of conduct
5. The firm has a framework that promotes and sustains among all employees the desired conduct

Accommodating remote working

There is recognition that, overall, firms' existing governance arrangements and controls have fared reasonably well during extended lockdown periods. However, the pandemic has given firms and regulators an insight into how things could be done differently in a future where hybrid models of remote and office working are likely to be a permanent feature. Traditional risk management, oversight and controls are challenged by large-scale remote working. Firms will need to recalibrate their risk frameworks and rethink associated controls.

Regulators are thinking through what this means as regards their expectations of firms and their own supervisory practices. For example, the **Luxembourg** Commission de Surveillance du Secteur Financier (CSSF) has set out governance and security requirements for supervised entities to perform tasks or activities through "telework", which will come into force at end-September 2021 if the threat of the pandemic has receded. Many Luxembourg fund management personnel live in a neighboring member state, so working from home raises question about "substance" of the FMC.

The CSSF says that while all staff members of a Luxembourg entity can in principle work remotely, it will impose certain baseline requirements to ensure that key functions are still being performed in a physical office in the jurisdiction. Firms must ensure that staff working remotely are able to return to the office at short notice and that the amount of an employee's normal working time spent working remotely should be limited. Also, firms will need to carry out detailed risk assessments of their remote working arrangements and ensure that their IT and cyber-security arrangements are proportionate to the risks.

New fund manager regulations

Some jurisdictions are introducing new or amended regulations for FMCs. In **Saudi Arabia**, for instance, responsibility for fund authorization has been transferred from the central bank to the Capital Markets Authority. In **Cyprus**, the "Mini Manager Law" was enacted in July 2020, creating a regime for the regulation and licensing of sub-threshold alternative investment fund managers. Prior to the enactment, such firms were not subject to licensing in Cyprus. A draft law on the regulation of fund administrators is in progress.

The **China** Securities Regulatory Commission (CSRC) has consulted on new measures and implementation provisions for the supervision and administration of public-offered securities investment fund managers. The aim is to revise and improve the 2012 measures for FMCs, by improving the approval process, strengthening on-going supervision, optimizing the public fund management license mechanism and enhancing the governance structure of FMCs.

Product governance expectations increase

Regulators are re-asserting the importance of robust product governance arrangements, in the interests of market stability and investor protection. Market stresses and volatility have impacted underlying assets and the management of clients' and funds' portfolios, which have led to a renewed emphasis on liquidity management and stress testing (see chapter 4). Regulators are also concerned that product development and distribution methods should genuinely be aligned to investors' best interests, and they are having regard to moves to sustainable investing.

The **Australian** Securities and Investments Commission (ASIC) published in December 2020 a new regulatory guide on product design and distribution obligations. Firms are required to design financial products to meet the needs of consumers, and to distribute their products in a more targeted manner. The obligations will take effect in October 2021, having been deferred by six months due to the pandemic. ASIC Acting Chair, Karen Chester said *"The design and distribution obligations are a game changer. They are designed to embed a consumer-centric approach and assist industry to deliver better outcomes for consumers while managing non-financial risks and avoiding costly remediation"*.

The **European** Securities and Markets Authority (ESMA) clarified the compliance function's role in product governance in June 2020. It said the compliance function should be formally involved in the development and maintenance of a firm's product governance framework, policies and processes. Further, ESMA expects the compliance function to play a part in each fund or service approval, whether relating to manufacturing or distribution. In practice, this means that the compliance function should have an effective and objective impact on the firm's process, and that the product governance framework must genuinely shape and challenge fund/service design, distribution proposition and value for the client/fund investor.

Product governance: the product lifecycle

ESMA subsequently launched in February 2021 a common supervisory action with national regulators on the application across the EU of the product governance rules in the Markets in Financial Instrument Directive (MiFID II). The aim is to ensure consistent implementation and application of the rules and to enhance the protection of investors. It will assess:

— How managers ensure that the costs and charges within funds are compatible with the needs, objectives and characteristics of their target market and do not undermine the fund's return expectations

— How managers and distributors identify and periodically review the target market and distribution strategy

— What information is exchanged, and how frequently, between manufacturers and distributors

Meanwhile, in the same month, the **UK** Financial Conduct Authority (FCA) published findings of its review into the product governance arrangements of eight asset managers. The FCA believes there is significant scope for firms to improve their product governance arrangements and to align them to the rules. The key failings identified were:

— Product design: not appropriately considering the product's "negative" target market and not assessing conflicts of interest at a sufficiently granular level of detail

— Product testing: stress and scenario testing were either too backward-looking or too generic (not addressing product-specific characteristics)

— Distribution: insufficient due diligence conducted on distributors at outset and insufficient procedures for monitoring management information

— Governance and oversight: ineffective oversight by second line, poor record-keeping and inadequate training

There is more to come for **EU** asset and fund managers. Amendments to rules under the UCITS[1] Directive, the Alternative Investment Fund Managers Directive (AIFMD) and MiFID II require firms to consider clients' sustainability preferences in suitability assessments and to embed consideration of sustainability risks into their product governance and risk management processes. In its advice to the Commission on the amendments, ESMA noted that asset managers will have to set up new controls and potentially hire more staff, so that firms have *"sufficient human and technical resources for the assessment of sustainability risks".*

Capital markets activity

Regulators are keen to ensure that the activities of investment managers in the capital markets are always in the best interest of, and support good outcomes for, their clients and fund investors. They are also concerned that smaller companies should be able to raise capital, to support economic recovery, and that investment managers should have access to market data.

In September 2020, the MAS published a notice and related guidelines on execution of customers' orders in connection with dealing in capital markets products, fund management or real estate investment trust management. The notice sets out requirements for financial institutions in **Singapore** to have policies and procedures to place and execute customers' orders on the best available terms, so as to support fair outcomes for customers.

The first stage of the **EU**'s review of MiFID II has introduced an exemption from the investment research rules in relation to small- and medium-sized enterprises (SMEs) and fixed income. Payment for research on such companies will no longer need to be unbundled from the cost of execution of transactions. The next stages of the review will cover many of the wholesale market rules, including pre-and post-trade transparency. The **UK** FCA is mirroring the EU's review, but with some differences in detail. For example, on the rules on payment for research, the FCA is proposing to exempt SMEs with market capitalization of below GBP 200 million, as opposed to the EU threshold of EUR 1 billion.

Good stewardship of investments

Rules have changed for both investment manager and investee companies. For instance, revisions to the **Japanese** Corporate Governance Code regarding the exercise of the functions of the board of directors require at least one third of independent outside directors for listing on the prime market, diversity in the core human resources of a company, sound group governance (including issues related to the listing of subsidiaries) and the reliability of audits.

In July 2020, the **US** SEC adopted amendments to rules governing proxy voting advice. The aim is to ensure that clients of proxy voting advice businesses have reasonable and timely access to more transparent, accurate and complete information on which to make voting decisions. The SEC issued supplemental guidance to assist investment advisers in assessing how to consider additional information from issuers that may become more readily available due to the rule amendments. The guidance also addresses circumstances where the investment adviser utilizes a proxy advisory firm's electronic vote management system, and disclosure and client consent obligations.

SEC Acting Chair, Allison Herren Lee said in March 2021 that she wants to see clearer disclosures on how asset managers cast shareholder votes. Voting information is *"unwieldy, difficult to understand, and difficult to compare across fund complexes",* she said. She envisions a new rule that could mandate more standardized and timely disclosures, and potentially make clear the number of shares where fund managers decline to exercise their vote. Also, there may be a disconnect between passive index funds' proxy voting and their investors' sustainability inclinations.

Key considerations for firms

- **Have we reviewed and updated the composition of our board? Is there strong board engagement and challenge?**
- **Are the design and operation of our corporate governance arrangements still appropriate, given our business strategy and culture? Are we able to make well-informed and well-evidenced decisions?**
- **Are we able readily to identify individual responsibility and accountability, without overlaps or gaps? Have any senior responsibilities changed in response to the pandemic, or should they?**
- **Are our risk management framework and controls fit-for-purpose given continued and large-scale remote working? Have we documented any changes, and can we evidence that our governance, risk management and controls work well in practice?**
- **Are our product governance arrangements fit-for-purpose, aligned to regulatory expectations, subject to robust and objective challenge, and delivering good customer outcomes?**
- **Are we following best and evolving practice in relation to stewardship of client assets, including proxy voting and engagement with investee companies?**

1. Undertaking for collective investment in transferable securities

07. Recalibrating investor protection

The perennial question for regulators about the optimal level of investor protection is now set against the backdrop of the impacts of the pandemic, the need to encourage greater private investment to aid economic recovery, and new technologies and increased digitalization. These drivers are calling into question whether investor protection rules need to be recalibrated, to capture better the broad spectrum of investors.

The functioning of retail markets is under view, with implications for both investment managers and distributors. Disclosure of costs and charges remains a regulatory imperative and is joined by concerns about advertising and marketing, the treatment of vulnerable customers and the safe keeping of assets. And pension reforms are having a significant impact on the industry and savers.

While much of the regulatory focus is on the retail markets, some regulations are being eased for professional investors and regulated market counterparties. In the **US**, for example, the Securities and Exchanges Commission (SEC) adopted amendments in August 2020 to the definitions of accredited investors and qualified institutional buyers. The amendments did not change the minimum income or wealth thresholds for individuals, but updated and improved the definition of accredited investor to identify more effectively investors that have sufficient knowledge and expertise to participate in investment opportunities that do not have the rigorous disclosure and procedural requirements, and related investor protections, provided by registration under the 1933 Securities Act.

> some regulations are being eased for professional clients.

Also, given an unusually high volume of comment letters from people identifying themselves as investors concerned about losing access to leveraged and inverse exchange-traded funds (ETFs), the SEC shelved a measure intended to protect such investors, saying it would review the issue later. As part of the new rules on use of derivatives in funds (see chapter 4), the SEC had proposed requiring broker-dealers and investment advisers to vet individual investors before approving them to trade the products.

The first stage of the review of the **EU** Markets in Financial Instruments Directive (MiFID II) came under the "Capital Markets Recovery" package, which was billed as adjusting legislation to allow capital markets to assist the recovery of the European economy. Amendments included:

- Exemption from the product governance regime for funds distributed exclusively to eligible counterparties
- Removal of the requirement to provide prescribed costs and charges information to professional clients and eligible counterparties (but they must still be provided information on investment advice and portfolio management)
- Retail clients will be able receive costs and charges information in digital format
- For at least two years while the Commission reviews the requirement, eligible counterparties will no longer receive, and professional clients can opt out of, quarterly best execution reports
- Exemptions from the rules on investment research in relation to small- and medium-sized enterprises and fixed income

The introduction of a new category of "semi-professional" investors, who might have access to a wider set of funds, will be consider under the next review stage. Other jurisdictions are also considering relaxing restrictions on eligible investors in certain types of funds and on overseas investors – see chapter 8.

In **Switzerland**, client advisers of foreign financial service providers that are prudentially supervised are exempted from a new obligation to register if the services they provide in Switzerland are exclusively for professional or institutional clients. There is some uncertainty about the position regarding clients who have opted up to professional status, but the Financial Market Supervisory Authority (FINMA) recommends registration.

Retail reviews conclude and begin

In **Australia**, the recommendations of the 2019 Royal Commission report are being progressed. They include rule changes relating to product intervention powers, suitability, governance, risk culture and accountability, and remediation of past customer detriment. In **Canada**, rules to enhance the relationship between clients, advisers and firms (referred to as the Client Focused Reforms or CFR) must be implemented in two phases during 2021: conflicts of interest and referral arrangements by end-June; and remaining changes (including relationship disclosure information related to conflicts of interest) by end-December.

CFR increases the burden on firms to oversee their advisers and facilitate outcomes in clients' best interest. Firms will need to review customer pathways, monitor pricing and service, and re-consider trailer-based products. More comprehensive product risk rating, and requirements to measure risk capacity, liquidity and concentration, will necessitate significant new data capture and reviews of product ranges. Firms must ensure consistency across their business lines, to mitigate conflicts of interest, and consider the role of managed portfolios. Suitability determinations will be more complex. Demonstrating compliance, especially suitability, will be challenging.

In December 2020, the **UK** Financial Conduct Authority (FCA) published the outcome of its long-standing review of retail distribution and the financial advice market. It found evidence of some improvements relating to people accessing advice, adviser numbers, and the rise in awareness and use of automated solutions, but the report was otherwise downbeat and indicates that there is more work to be done by firms. A core theme running through the findings relates to a lack of competition and poor value for money. The FCA is now proposing a new Consumer Duty, which will strengthen existing requirements and clarify the FCA's expectations of firms' cultures and behaviors.

The **EU** review of MiFID II was originally scheduled as one all-encompassing review but has now split into three stages. Up for discussion in stages 2 and 3 are whether to define non-structured UCITS[1] as "simple" products and exempt them from the product governance requirements, and payment of initial and ongoing commissions to distributors ("inducements"). At present, payments to independent financial advisers are banned and commissions paid to other distributors must "enhance the quality of the service to the client". The rules are regarded as complex and demanding, for both firms and national regulators, and have been implemented inconsistently across member states.

The European Commission is consulting until August 2021 on a wider review of the EU retail distribution landscape. The findings are expected in early 2022 and are likely to influence the MiFID II review and introduce further changes to fund information documents (see below).

1. Undertaking for collective investment in transferable securities

Continued focus on costs and disclosures

The 2021 priorities of the **US** SEC's Division of Examinations note that it is critically important that broker-dealers, investment companies and registered investment advisers provide investors with required disclosures on fees and expenses, and conflicts of interest, to enable the investing public to make better informed choices. Conflicts of interest, particularly those with the prospect of financial gain, can improperly influence a firm's fundamental obligation to act in investors' best interest, the SEC says. The Division will also focus on financial intermediaries' recommendations and disclosures involving ETFs, including adequacy of risk disclosure and suitability.

The third annual report by the European Securities and Markets Authority (ESMA) on the cost and performance of **EU** retail investment products found that retail fund investors continue to pay on average 40 percent more than institutional investors. Actively-managed UCITS outperformed passively-managed funds and ETFs on a gross basis, but the difference was not enough to compensate for the higher costs charged by active funds. The report also showed that actively-managed sustainable funds had lower costs than non-sustainable funds. ESMA suggested that this does not support a view that there is systematic "greenwashing" by sustainable funds.

ESMA had already identified costs and performance for retail investment products as a strategic supervisory priority for national regulators, noting that unfair and disproportionate costs and fees can increase investor detriment and affect investors' trust in financial markets. In early 2021, ESMA used its enhanced convergence powers to require national regulators to undertake a common supervisory action, to assess firms' compliance with the relevant cost-related UCITS provisions and the obligation not to charge investors undue costs.

The EU debate on amendments to the key information document for alternative investment funds (AIFs), insurance-based investment products and bank structured products (the "PRIIP KID") has split into two stages. After much debate and public disagreements between the Commission and the three European Supervisory Authorities, in May 2021 the Commission adopted final changes to the Level 2 rules. Firms have until June 2022 to implement the changes and to replace UCITS key investor information documents for retail share classes with the revised PRIIP KID. There may be further changes, depending on the findings of the wider retail distribution review (see page 41).

Advertising and marketing

The **Spanish** Comisión Nacional del Mercado de Valores (CNMV) issued new rules in November 2020 governing the marketing of investment funds and services in Spain. The proposal covers firms' controls and processes for the advertising of funds, and on the content and format of marketing material, including where they commission third parties to perform these activities. The aim is to ensure that the advertising of funds is subject to similar criteria and requirements as apply to banking products. The CNMV is now reviewing its guidelines on appropriateness.

In December 2020, the **US** SEC adopted rule and form amendments to modernize the regulatory framework governing investment adviser advertising and payments to solicitors. Among other things, the updated requirements on advertising are more technology-neutral, eliminate unnecessary or outdated requirements, and rely more expressly on compliance policies and procedures. Certain of the original proposals were not adopted, such as a distinction between retail and non-retail investors, and more onerous requirements for advertisements that display predecessor performance.

The definition of advertisement covers two broad categories of communications:

- An adviser's direct or indirect communication made to more than one person (or to one or more persons if the communication contains hypothetical performance) that offers current or new services to prospective clients or investors in a private fund advised by the adviser
- Any endorsement or testimonial for which an investment adviser provides (cash or non-cash) compensation, directly or indirectly

There are general prohibitions concerning advertisements, requirements for testimonials and endorsements, provisions regarding inclusion of third-party ratings in advertisements, and requirements pertaining to performance advertising. Firms must comply with the new requirements by November 2022.

In response to consumer bodies calling for a ban on the active distribution of certain types of AIFs to retail investors, the **German** government has enacted regulations designed to strengthen investor protection, which include new rules on "pre-marketing" and other provisions. As per EU legislation, pre-marketing is defined as the provision of information or communication, direct or indirect, on investment strategies or investment ideas by an AIFM or on its behalf, to potential professional or semi-professional investors. The AIF manager will have to notify the regulator before the fund is marketed, and only the manager and certain other authorized entities will be able to carry out pre-marketing.

ESMA has consulted on guidelines on marketing communications under the regulation that is intended to facilitate cross-border distribution of funds within the **EU** (see chapter 8). Key points are that a communication must be identifiable as marketing material, describe in an equally prominent manner the risks and rewards of investing in funds, and contain information that is fair, clear and not misleading. The final guidelines are expected by August 2021.

The **UK** government has consulted on limiting the scope of firms that can approve the financial promotions of unauthorized persons. "Financial promotions" are communications of an invitation or inducement to engage in investment activity. A firm must not communicate a financial promotion unless the firm is FCA-authorized or the content of the communication is approved by an authorized firm, subject to certain exemptions. It is proposed that an authorized firm will have to obtain specific consent from the FCA prior to approving a financial promotion that an unauthorized firm wishes to communicate. The consultation considers two options for how this might work in practice.

Meanwhile, the FCA is consulting on how best to stop fraudulent and unethical investment pitches being made to non-professional clients. It is concerned that a growing number of laypeople are using online services to buy into *"inappropriate high-risk investments that do not meet their savings goals and investment needs"*. Investment scams enabled by online advertising have spread widely, fueled by people spending more time on computers during lockdowns. The FCA is considering new ways of classifying high-risk investments. Also, it has instigated a new "repeat breacher" policy on financial promotions.

Focus on vulnerable customers

The pandemic has heightened incidences of vulnerable customers and awareness by regulators. Concerns about the treatment of vulnerable customers by banks and insurers are now spilling over onto asset managers and investment funds. Customers, including usually sophisticated and experienced clients, can exhibit characteristics of vulnerability at specific points in their lives, such as due to poor health, negative life events, low financial resilience, or low or diminished capability. Not all people with these characteristics will suffer harm, but regulators are concerned that such characteristics may limit people's ability to make reasonable decisions or put them at greater risk of mis-selling.

For instance, the **UK** FCA's latest guidance seeks to drive improvements so that vulnerable customers are consistently able to achieve outcomes that are as good as for other customers. This should apply through the whole customer journey, from product design through to customer engagement and communications. Firms must be able to demonstrate how their business model, the actions they have taken and their culture ensure the fair treatment of all their customers.

Safekeeping of fund assets

New requirements are in place for fund depositaries and custodians in **China**. The revised measures, introduced in July 2020, set out the general duties and obligations of fund custodians regarding custody, settlement and clearing, valuation, disclosure and reports, investment supervision and review of distributions. If the fund manager fails to convene a fund unitholders' meeting, the custodian must do so. Also, they must now keep the accounting documents, transactions records, fund contract and other material documents for at least 20 years.

In **Hong Kong (SAR), China**, firms acting as depositaries of funds authorized by the Securities and Futures Commission (SFC) and offered to the public will be subject to SFC regulatory oversight. The depositary is defined as the entity at the top of the chain of entities that have custody of the fund's assets, and it has responsibility for all delegates down the custodial chain. Both the depositary and key personnel must be licensed by the SFC, and the depositary is subject to requirements on fitness and properness, capital, professional indemnity insurance, conduct and internal controls.

In 2022, ESMA will undertake a discretionary peer review of the depositary obligations for **EU** funds, focusing on the oversight and safekeeping functions of depositaries.

Pension reforms

Helping companies to provide pensions for employees and individuals to save personally for retirement are critical services that asset managers and investment funds provide. Therefore, any changes in saving or withdrawal levels or in pension regulation can have a significant impact on both the industry and savers.

Given income losses and increased medical needs during the pandemic, the level of retirement savings has fallen, and many individuals have faced such financial hardships that governments, for instance in **Mexico**, have eased the restrictions around withdrawing monies from pension savings before retirement. The **Malaysian** Employee Provident Fund was reported in February 2021 as having already approved nearly MYR 20 billion in hardship withdrawals, and contributions net of withdrawals fell by over 35 percent in 2020 compared to the previous year.

Around AUD 32 million was withdrawn from **Australian** superannuation funds under an early release scheme designed as part of the pandemic response. A new portal – "Your future, your supra" – lists funds in order of performance net of fees, and the mandatory retirement savings rate is due to increase to 9.5 percent of salary from July 2022. The government is reviewing the retirement system and initial ideas are expected to be novel.

> "... any changes in saving or withdrawal levels or in pension regulation can have a significant impact on both the industry and savers"

In previous years' reports, we noted that the **Swedish** premium pension system was undergoing major reform and that the number of investment funds available for savers to choose from was expected to fall dramatically. The aim of the reforms is to raise standards and reduce the risk of savers buying "second-rate" products. The number of funds has already fallen by one third, to about 500, and is expected to fall to less than 200 funds after a new procurement-based system is introduced by end-2021. A new authority will be responsible for ensuring a sufficiently broad selection of funds is on offer – in terms of risk level and investment objective – and will select funds that are cost-effective, sustainable and high quality.

In March 2021, the **UK** Pension Regulator issued its 15-year strategy for protecting savers, which focuses on the short-term challenges of the pandemic and reflects the shift towards defined contribution arrangements. Its strategic priorities include security of savings, value for money (savings well-invested, reasonable costs and charges, and good quality, efficient services), scrutiny of decision-making and embracing technology.

Key considerations for firms

- **How might the categorization of our client and investor base be impacted by changing regulatory definitions, and what opportunities for product offerings might arise?**
- **Do we have, and can we evidence to our regulator that we have, a client/investor-centric approach throughout our business?**
- **Do we seek to minimize costs incurred by clients and investors and to maximize the value of our services and funds?**
- **Are all our disclosures clear, fair and not misleading, and would they stand up to independent scrutiny and challenge?**
- **Do we have strong controls and processes around advertising and marketing, including by third parties?**

08. Redrawing borders and products

Many jurisdictions continue to open their markets to overseas firms and investment, and more international financial centers are being established. New or amended fund structures are being introduced to enable jurisdictions to compete with well-established fund domiciles and to cater for private investment in long-term assets, to assist economic recovery.

The UK's departure from the EU (Brexit) is having wider impacts, both within the EU bloc and for other third countries. In particular, the EU debate on substance and delegation could have wide ramifications for the industry.

Welcoming overseas firms and investment

China continues to open its capital markets to foreign firms and investors. In November 2020, changes to the rules for Qualified Foreign Institutional Investors (QFIIs) and RMB QFIIs (RQFIIs) were implemented. A wider range of financial transactions are now permitted (including government-backed bonds, bond repos, and securities borrowing and lending), the application and review procedures have been streamlined, and QFIIs/RQFIIs can select from a wider range of clearing participants. The Shanghai and Shenzhen Stock Exchanges have lowered the shareholding percentage of foreign investors in a single listed company that triggers the initial information disclosure obligation, from 26 percent to 24 percent.

Since April 2021, the China Securities Regulatory Commission (CSRC) has allowed eligible foreign financial institutions to set up wholly foreign-owned fund management companies. However, the rules on eligibility have also changed, with some requirements being eased, but more of them raising the eligibility threshold. Also, the requirements for the actual controller of the company are strengthened and the minimum number of personnel involved in research, investment, operations, sales, compliance and other business has been increased from 15 to 30.

Chinese branches of foreign banks can now apply for a custodian licence for publicly- or privately-offered funds. The revised measures set out the general duties and obligations of fund custodians regarding custody, settlement and clearing, valuation, disclosure and reports, investment supervision, review of distributions and governance.

The Chinese State Administration of Foreign Exchange (SAFE) is planning to change the cross-border investment management rules involving private equity funds. The regulator will expand pilot schemes to support forex settlements in free trade zones, while combatting financial risks in cross-border capital flows and criminal activities like cross-border gambling.

The Greater Bay Area Wealth Connect scheme has been further developed. It will provide mutual market access between **Hong Kong (SAR)** and **Mainland China** for wealth management products. The intention is to improve the RMB liquidity pool in Hong Kong and strengthen its role as an offshore RMB center. Hong Kong (SAR), China has also continued to expand its suite of fund recognition agreements, including with **Thailand** and **Switzerland**.

Japan has established a system for the "International Financial Center" concept. The December 2020 report of the Financial System Council's Working Group on Market Institutions includes recommendations on acceptance of overseas investment managers and the relaxation of firewall regulations on exchange of information on foreign corporate customers. The working group is now compiling a further report on how to supply growth capital and regulation of information exchange between banks and securities companies regarding domestic customers. Among the issues considered under supply of growth capital are stimulating the issuance and circulation of unlisted shares and facilitating the use of venture capital and private equity funds.

Indian International Financial Services Center (IFSC)

The IFSC, which is set up in the special economic zone within Gujarat Internal Finance Tech-City ("GIFT City"), is technically located on Indian soil but is considered an offshore jurisdiction for forex purposes. This enables investors to invest in businesses located within the IFSC without having to comply with India's forex regime. Also, special tax incentives have been provided to units located within the IFSC. The aim is to incentivize overseas financial institutions and overseas branches/subsidiaries of Indian financial institutions to bring more financial services transactions to Indian shores.

The IFSC Authority is the unified authority for the development and regulation of financial products, services and institutions in the IFSC. It is creating regulations intended quickly to bring the GIFT City IFSC in line with other IFSCs around the world.

Over the past couple of years, the Capital Markets Authority of **Saudi Arabia** has granted new licenses to firms wishing to operate in the jurisdiction. Most of these new entrants are global names looking to establish presence in Saudi Arabia, but so far only some have obtained asset management licenses. This situation is expected to evolve as Saudi Arabia continues to reform its capital markets in line with its "Vision 2030" to attract foreign investment.

The Securities and Exchange Commission of **Brazil** (CVM) has enhanced its investor adviser rules under "CVM 497". Firms are no longer required to have one exclusive administrator for a platform. Also, the rules for non-resident investors have been brought into line with those for domestic investors. They are now exempt from the obligation to contract with a custodian registered with the CVM and can leave their Brazilian funds in the hands of a third-party intermediary hired in Brazil, potentially saving BRL 35,000 to BRL 60,000 a year.

Competitive fund domiciles

Various regulatory reforms and tax incentives were introduced in 2020 to encourage local market growth, to cement **Hong Kong (SAR), China**'s position as the region's premier asset and wealth management hub, and to bring firms and investment structures onshore. The new Limited Partnership Fund (LPF) regime, which caters for funds invested in private and real assets, took effect in August 2020. The regime includes an opt-in registration scheme, with elements of investor protection built in.

There have also been changes to the Code for Open-ended Fund Companies (OFCs), which brings it into line with the new LPF regime, including on anti-money laundering requirements. All investment restrictions on private OFCs have been removed and the type of firms that can act as custodians for private OFCs has been expanded (including overseas intermediaries). However, new provisions require that investment managers and custodians have sufficient expertise and experience in managing and safekeeping asset classes in which an OFC invests. There are also enhancements on risk disclosure in offering documents and record-keeping.

The Government has announced subsidies of up to 70 percent of expenses paid to local professional service providers of OFCs set up in or re-domiciled in the coming three years, subject to a cap of HKD 1 million per OFC. A similar subsidy will be offered for qualifying REITs,[1] subject to a cap of HKD 8 million per REIT. The first **Chinese** public REIT has been submitted to the Shanghai and Shenzhen Stock Exchanges for approval. It will help local governments finance infrastructure projects and allow retail investors to tap into a growing market. Also, autumn 2020 saw the first batch of exchange-traded funds (ETFs) authorized under a scheme that facilitates cross-listing of ETFs between Hong King (SAR) and Mainland China.

1. Real estate investment trusts

An amendment to the **Cayman Islands** Private Funds Act was introduced in July 2020 to clarify the definition of a private fund. And from August 2020, open-ended mutual funds have to register with the Cayman Islands Monetary Authority (CIMA), pay an annual fee and file an annual return to CIMA, have their accounts audited by a CIMA-approved auditor and filed within six months of each financial year-end, and have at least two natural persons as operators who are registered under the Director's Registration and Licensing Law. Failure to comply could result in administrative fines by CIMA. Private funds in **Bermuda** must now be registered, but no external audit requirement has yet been imposed.

The minimum amount of domestic investments held by private equity funds in **Brazil** has been reduced from 80 percent to 50 percent. For public funds there are new rules on limited liability for investors, the ability to have different share classes and the ability to invest up to 100 percent offshore (previously, there was a 20 percent limit). Likewise, **South Africa** is proposing changes to investment limits. Current requirements impose maximum percentages in different asset classes to ensure diversification (so, a fund cannot hold only equities, for example). To encourage infrastructure investment, the maximum of 5 percent in alternative asset classes is changing to not more than 45 percent in domestic projects, with a limit of 25 percent in a single entity, and a maximum of 10 percent in overseas projects.

New legislation forms part of the **Irish** government's strategic priority for the development of the international financial services sector to 2025, including seeking to make Ireland the domicile of choice for private fund managers looking to access European capital via a partnership structure. In addition to enhancements to the Investment Limited Partnership (ILP) regime for funds invested in private and real assets – bringing ILPs in line with other existing Irish fund structures and on par with regimes in other jurisdictions, such as **Luxembourg** and **Jersey** – the Central Bank of Ireland (CBI) has provided wider guidance on the application of its Alternative Investment Fund (AIF) Rulebook to closed-ended Qualifying Investor AIFs ("CE QIAIFs").

The CBI's guidance is limited to those CE QIAIFs that use private equity-type strategies or invest in illiquid assets. It allows CE QIAIFs flexibility regarding the operational use of share classes, in line with private equity industry norms. It introduces differentiated share classes, the allocation of returns of an asset to a specific share class and participation in a share class other than on a pro rata basis. It permits CE QIAIFs to issue shares other than at net asset value, sets out "excuse and exclude" provisions, permits staged investing and permits management participation in share classes.

In **Switzerland**, an amendment to the Collective Investment Schemes Act, introducing the Limited Qualified Investor Fund (L-QIF), was delayed due to the pandemic and provision will enter into force at the beginning of 2022 at the earliest. L-QIFs will not be subject to authorization, will be open only to qualified investors (such as insurance companies and pension funds), and will have to be managed by an

Key features of Irish ILPs

— May have no investment or borrowing limits, depending on how the fund is created

— Can be umbrella funds with segregated liability between sub-funds

— Can be passported to professional investors in the EU

— An extensive and enhanced list of safe harbor provisions permits investors to undertake certain actions without being deemed to be taking part in the management of the ILP

— Requirement for all limited partners (LPs) to approve amendments to the LP agreement is replaced by the need for approval by a majority of general partners (GPs) and LPs

— Amendments can be made without LP approval in certain instances

— The statutory transfer of assets and liabilities on a change of GP is permitted without further formalities

— Upon the withdrawal of a GP, all rights, property, debts and obligations of the ILP will continue to be held by, or the liability of, the remaining GPs without further formality

— The GP does not have to certify that the ILP is able to pay its debts in full as they fall due after the return of capital to an LP is completed

— Facilitates distribution waterfall and carried interest arrangements

— Can be redomiciled into and out of Ireland by way of continuation

— Permitted to "check the box" from a US tax perspective

— Beneficial ownership requirements like those for other fund structures

The ILP structure can be used by AIFs and their managers. The CBI has confirmed that the general partner of the ILP does not need to be regulated as an AIFM, rather they will appoint the AIFM. It will, though, be subject to the fitness and probity regime, with directors or partners of a GP constituting "pre-approval controlled" functions, which must be signed off by the regulator.

institution authorized and supervised by the Financial Market Supervisory Authority (FINMA). Because L-QIFs will not be subject to authorization, they will be able to be launched faster and at lower cost, and they will be subject to more liberal investment and risk diversification rules.

In January 2021, the **German** government published a draft bill to strengthen its appeal as a fund domicile, by a mix of supervisory and fiscal measures. The new law will also implement EU guidelines for cross-border distribution (see page 51). New fund structures and changes to the rules for existing vehicles will be introduced to bring Germany on par with other jurisdictions:

- Closed-ended contractual schemes will offer an alternative to existing investment limited partnerships and investment stock corporation structures
- Open-ended real estate funds in the form of investment limited partnerships will be available to professional and semi-professional investors
- Open-ended contractual infrastructure funds will be subject to certain investment restrictions on eligible assets and exposure limits, to allow retail investors to participate in the returns of infrastructure investments
- Clarifications around the use of shareholder loans in real estate funds for efficient structuring purposes
- Increased leverage limit for real estate special funds with fixed investment conditions, from 50 percent to 60 percent
- Closed-ended master feeder structures for retail AIFs
- Special funds may be used to create "development promotion" funds investing solely in sustainable assets

The **UK** government consulted until April 2021 on the UK funds regime. The overarching objective of the review is to identify options that will make the UK a more attractive location to set up, manage and administer funds, and that will support a wider range of more efficient investments better suited to investors' needs. The review is wide-ranging, covering law and regulation, tax laws, fund administration and other considerations. Any reforms must be compatible with the UK's robust approach on tax avoidance and evasion, and its commitment to upholding the highest standards of regulation, appropriate supervisory oversight and investor protection.

Factors to consider in the choice of fund vehicle

2. Undertaking for collective investment in transferable securities

The review does not impact the rules for UK UCITS[2] and AIFs (which are the on-shored EU rules) but is focused on the need for changes to product and tax rules to accommodate long-term asset funds (LTAFs) and for additional legal structures for professional funds. New vehicles under consideration are incorporated and contractual funds that are registered, but not authorized or listed, and have an authorized manager and depositary. They would complement existing non-authorized unit trusts and partnerships, creating a versatile suite of options for domestic and overseas professional investors. Changes to the existing regime for authorized open-ended funds for professional investors are also under consideration, to facilitate their investment in long-term assets such as infrastructure projects.

Guernsey has been added to the list of those jurisdictions that permit cannabis funds. The fund manager must ensure that it is legal to invest in such assets in each jurisdiction and that the cannabis is not for recreational use.

Brexit: wider impacts

Negative impacts to the financial markets were avoided at the end of the **UK** transition period out of the **EU**, in large part due to the preparations undertaken by regulators and market participants. However, the commercial and operational implications of the new EU-UK border continue to evolve. Regulatory developments since the UK left the EU underline that firms working in the EU, the UK and elsewhere need to monitor regulatory change in both jurisdictions, to pre-empt disruption to their business and remain compliant.

For example, in January 2021, the European Securities and Markets Authority (ESMA) issued a reminder to firms about the use of "reverse solicitation" under the Markets in Financial Instruments Directive (MiFID II). It highlighted *"questionable practices"* by firms, including the use of general clauses in terms of business and online "I agree" pop-up boxes. Where a third-country firm solicits clients or potential clients in the EU, or where it promotes or advertises investment services or activities together with ancillary services, this should not be deemed as a service "provided at the own exclusive initiative of the client", so does not fall under the reverse solicitation provision.

The EU and the UK have agreed the text of the Memorandum of Understanding (MoU) that creates a framework for voluntary regulatory co-operation on financial services. The MoU will establish the Joint EU-UK Financial Regulatory Forum, which will facilitate dialogue on financial services issues. Like the EU-US Forum, it will meet twice a year and on other occasions when deemed necessary. The UK is seeking to upgrade its relationship with the **US** to secure permanent access for UK firms to US securities and derivatives markets.

In January 2021, the finance ministers of **Switzerland** and the UK agreed the next steps for negotiations on a mutual recognition agreement in the financial sector. Switzerland has also agreed revised bilateral agreements with several EU member states. However, Brexit uncertainties led to delays in procedures at national regulators, due in part to the volume of applications.

EU debate on substance and delegation

Firms should factor into their thinking the ongoing EU debate on delegation and substance, which has been raised again in the review of the Alternative Investment Fund Managers Directive (AIFMD). ESMA's report to the Commission raised many issues, including the need to clarify aspects of the delegation provisions and to extend them to UCITS management companies, because Brexit has increased the proportion of functions delegated by EU funds outside the bloc. Most regulators in the EU recognize, though, that the delegation of portfolio management, both within the EU and to third countries, can provide EU investors with the best knowledge and skills from around the globe. Steven Maijoor, ESMA Chair made this point clearly in post-speech remarks in November 2020. He said there was no wish to change the current model, only to clarify it and mitigate the risk of over-concentration.

ESMA also says there is a need to harmonize the supervision of cross-border entities. The **French** Autorité des Marchés Financiers (AMF) agrees. It suggests that for each manager that markets AIFs cross-border within the EU, a lead supervisory role should be assigned to one regulator, which should have comprehensive access to relevant supervisory information on all funds managed by that entity.

The practice of delegation by **Spanish** fund managers to third-country portfolio managers (without a physical presence in Spain) is reported to have increased significantly. The Comisión Nacional del Mercado de Valores (CNMV) wants to ensure that Spanish managers do not delegate to providers that are poorly equipped to offer external investment services. It has consulted on technical guidance designed to ensure external advisers have the "proper honour, knowledge and experience as well as the necessary technical means". Spanish fund managers must also establish procedures to control the activity of external advisers, to avoid potential conflicts of interest and to ensure adherence to funds' investment policies and risk limits.

EU entities may need to have increased in-house skills and more experienced staff. Also, regulators want to ensure that fund managers are controlling outsourcing risks (see chapter 5). Looking forward, some member states are suggesting that the EU's current use of equivalence (whereby it depends on the rules of and supervision by a third-country regulator) should be replaced by a requirement for third-country firms to register in the EU and to comply with EU rules.

The new EU-UK border for investment managers and funds

Investment managers and funds can no longer use the EU passports across the new EU-UK border, in either direction. "Equivalence" is not provided for in all legislation and does not replace the loss of passports, but it can ease the impact of the new border in certain areas. The UK has issued several equivalence decisions on the EU, but at the time of writing, the EU has issued only two time-limited decisions on the UK and it is not certain that more will be issued.

For investment management services provided to **wholesale counterparties and professional clients,** the critical questions are whether the EU will issue a MiFID equivalence decision on the UK or what individual member states may allow in their own jurisdictions. There is no MiFID equivalence provision for **retail clients.** It is for each member state to decide whether and under what conditions it will permit third-country entities to market or provide financial services to retail customers in their own jurisdiction, what constitutes new business and whether pre-existing client relationships can continue to be serviced.

The delegation provisions in the UCITS Directive and AIFMD require co-operation agreements between regulators (not equivalence decisions). EU/EEA **fund management companies** can continue at present to delegate investment management functions to UK and other third-country firms, subject to any national requirements. However, the reviews of AIFMD and UCITS could herald changes, in EU rules or supervisory expectations.

Some member states – for example, **Luxembourg** and **Italy** – have allowed UK firms to continue to provide services to clients in their jurisdiction on a temporary basis or until they obtain authorization in that state, but such bilateral provisions generally fall away at end-June 2021. UK funds can apply under individual member states' national private placement regimes (NPPRs), but where such regimes exist, they tend to relate only to professional investors.

On the other hand, the UK's Temporary Permissions Regime (TPR) allows EU/EEA firms and investment funds that registered by end-2020 to continue to operate in the UK for up to three years on the same basis as pre-Brexit (the regime does not cover new funds or certain new sub-funds that are launched post-December 2020). TPR firms and funds are expected to apply for authorization or registration by the UK Financial Conduct Authority (FCA) before the regime ends.

After the demise of TPR, EU/EEA investment funds wishing to market into the UK would either have to comply with the UK's NPPR or have to apply to be registered by the FCA, which requires each fund to be considered on a case-by-case basis. The proposed Offshore Funds Regime will ease this process. Funds from countries whose fund regimes are judged by the FCA to be equivalent will be able to register with the FCA via a much-simplified process. It is not yet certain what additional requirements will be imposed for third-country funds marketed to UK retail investors.

EU Capital Markets Union (CMU)

EU/EEA member states have until August 2021 to implement a directive on the cross-border distribution of funds, which aims to remove remaining national barriers and ensure transparency of national regulatory fees and requirements. The **European** Commission continues to pursue initiatives to boost private investment within the EU, amid concerns that banks remain too dominant across distribution channels and the need to generate economic growth and to support sustainable and digital finance initiatives. The Commission is considering the final report of its high-level CMU working group, which has three overarching themes: promoting simplicity, enabling competition and creating an equity culture.

The report delivered the clear message that the EU needs CMU more than ever post-Brexit. It proposed a set of measures relating to the financing of business, market infrastructure, individual investors' engagement and obstacles to cross-border investment. Of special note for asset managers and investment funds are:

— A targeted review of the framework for long-term investment funds (ELTIFs)

— A targeted review of the Shareholder Rights Directive II

— Targeted amendments to MiFID II and the fund key information document to improve disclosure

— Amendments to MiFID II to improve the fairness and quality of financial advice

— Creation of a voluntary pan-European quality mark for financial advisors

— A study on the role of inducements for the adequacy of advice

As at June 2020, only 25 ELTIFs had been set up (eight of which were not marketed), with only EUR 1.5 billion funds under management in total. The Commission's consultation on the ELTIF framework sought views on the scope of authorization, eligible assets and qualifying portfolio undertakings, borrowing and leverage, conflicts of interest and co-investment, and portfolio composition and diversification. Several more ELTIFs have now been set up in **Italy**, encouraged by tax incentives. Tax incentives are being considered in other jurisdictions. For example, with a view to encouraging **Luxembourg** funds to invest in sustainable economic activities, the annual subscription tax rate for such funds has been reduced from 0.05 percent to 0.01-0.04 percent.

The Commission has published a staff working document on its evaluation of the Distance Marketing of Consumer Financial Services Directive (DMD). The evaluation acknowledges that the objectives of the DMD were in line with the expected needs of consumers and financial services providers when it was introduced and that some objectives remain relevant. However:

— Developments in new selling practices, especially in the context of digitalization, and consumer behavior trends reveal that some consumer needs, including understanding of online pre-contractual information, are not addressed properly in the DMD.

— The objective of single market consolidation has been achieved to a limited extent, but consumers and providers still face barriers in providing or accessing cross-border financial services.

— The subsequent adoption of product-specific and horizontal legislation has reduced the relevance of the DMD in some markets.

— The enforcement landscape varies across member states, which points to the need to step up enforcement activity.

Key considerations for firms

— **Are we seizing opportunities to invest in new markets and international financial centers?**

— **Do we wish to take opportunities to invest in new asset classes? If yes, do we have the necessary skills and resources?**

— **Are we monitoring the creation of new fund vehicles and considering what opportunities there might be to expand our product suite?**

— **Have we understood and fully analyzed the wider impacts of Brexit on our business?**

— **Are we keeping abreast of regulatory debates on substance and the potential impacts on delegated activities?**

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