



# A sea of voices

**Evolving Asset Management  
Regulation report**

June 2019

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# Executive summary

The asset and fund management industry has grown significantly in the last decade, with surveys indicating about 65 percent growth since 2007, to over USD 80 trillion in assets under management worldwide.

As its importance to the world financial system – linking those with money to invest with enterprises and activities that require funding – is increasingly recognized, so both the industry and the regulators that police the sector become more prominent.

The industry and regulators are coming under pressure from a range of “external” voices – demanding investors and consumer groups, clamoring political and economic needs, changing priorities and hopes of civil society, an increasingly noisy press, the explosion in social media and the rapid growth of new technologies.

**This sea of voices is directly influencing the regulatory agenda and increasing expectations on the industry. A fundamental rethink of firms’ mindset and investment offerings is required.**

Structures and remits are in flux as **regulators and supervisors** adapt their agendas and working methods to a changing environment. Supervision of the sector is both broadening and deepening, and supervisors are turning to technology to help them perform their roles more efficiently.

There is new rule-making in some areas and in some jurisdictions, but agendas are increasingly focused on the monitoring and review of the myriad of post-crisis rules. There are demands from policy-makers and regulators for yet more data, and there are demands from the industry and institutional investors for a rationalization of requirements and for greater global regulatory convergence.

The identification and containment of **systemic risks** became the overwhelming priority of policy-makers and regulators after the 2008 financial crisis. Eleven years on, the financial crisis is now a distant memory for many, but policymakers are still highly attuned to the fragility of markets. Again, there are calls for more data.

As the asset management industry expands, so debate around it intensifies, but there are conflicting views about the most appropriate regulatory response. Regulators are

“ It is no longer enough for firms simply to adhere to rules and regulations. They need to think more broadly about the impact of their culture and conduct. ”

deepening their examination of systemic risks in the sector, with a focus on liquidity and leverage. Exchange-traded funds and money market funds remain on the watch list.

As we emphasized in last year's report, **governance and conduct** are global regulatory preoccupations. That ethos is spreading. It is no longer enough for firms simply to adhere to rules and regulations. They need to think more broadly about the impact of their culture and conduct. The public loudly demands that firms serve their clients with skill and care.

There are increasing calls worldwide for individuals within the financial services industry to be held personally to account for their action. Diversity, remuneration and stewardship are all on the agenda. Fund distribution and financial advice rules are being further strengthened, and the industry's governance of delegated or outsourced activities is under scrutiny.

The regulatory search continues for perfect disclosures to investors, with a focus on the calculation and presentation of **costs and charges**. A small but increasing number of regulators are also probing the *level* of costs, in response to persistent voices that call for a different equilibrium to be found between what is reasonable for investors to be charged and the profits of investment firms. “Closet trackers”, the use of benchmarks and performance fees are all under the regulatory microscope.

Many **markets are opening**, but others are becoming more restrictive and there remain frictions in the cross-border distribution of investment funds. In particular, “Brexit” is impacting cross-border flows between the UK and the rest of the EU, and this impact is likely to increase. Meanwhile, the EU regulatory approach to delegation is being more stringently supervised, with US and Asian firms potentially affected, too.

Elsewhere, use of the Asian fund passports remains low but is slowly rising. Bilateral fund arrangements are flourishing, developing economies continue to open up their capital markets to foreign firms and investors, and new fund structures seek to compete. Around the globe, there are new opportunities for asset managers and investment funds in the retirement savings market, but in some cases more conditions or restrictions are being imposed.

Voices arguing for **climate-aware investing** and carbon controls are increasing. Demand for ethical treatment of employees, customers and other stakeholders is also growing, as is indignation about poorly-managed companies. Consideration of environmental, social and governance (ESG) factors is now a must.

The investor voice is already having a significant impact on asset managers' investment processes and strategies. Regulators in some jurisdictions are seeking to catch up, but their responses vary, and industry and investor reactions to their proposals are mixed. Most, but by no means all, institutional investors believe sustainability should be incorporated into portfolios. However most, but not all, investors believe that ESG measures should not be mandated.

Meanwhile, **fintech** developments are coming thick and fast, and are already a powerful external driver of regulation. The regulators have a dilemma: they are called on to support and help nurture nascent industries that increase efficiency and help consumers to access financial services, but they are concerned about new and heightened risks, in particular the protection of personal data.

Regulators are rethinking how they regulate the industry, both new fintech entrants and existing businesses that are encompassing fintech developments. Existing conduct rules were largely written in a paper and face-to-face world. Are the rules fit-for-purpose in a digital age?

## Key questions for CEOs

- Are we fundamentally reviewing our business ethos and offerings in recognition of changing stakeholder demands?
- Are we anticipating evolving regulatory agendas and supervisory practices? Can our data management and analysis systems accommodate yet more data demands?
- Do our governance model, culture and conduct conform to new regulatory expressions of good practice and increasing client expectations, including accountability, remuneration, diversity and stewardship?
- Are our disclosures to investors transparent and meaningful, and do our services and products demonstrate an appropriate and acceptable balance between what investors are charged and the firm's profits?
- Are we quickly identifying new market opportunities and responding to increased restrictions?
- Do we recognise that consideration of ESG factors is now a must? Are we in front of or behind the curve in developing our investment processes and product offerings?
- Are we both embracing technological developments and ensuring full consideration of the attendant risks?



## Chapter 1

# Shifting structures, evolving agendas

As the importance of asset management to the world financial system – linking those with money to invest with enterprises and activities that require funding – is increasingly recognized, so the regulators that police the sector become more prominent.

Those regulators are facing new pressures that are increasingly emanating from “external voices” – investor concerns, social objectives, fintech developments, and economic and political imperatives.

These external voices are gaining in importance and cannot be ignored. They are leading to changing regulatory remits and, in some cases, changing structures as regulators and supervisors – at global, regional and national levels – adapt their agendas and working methods in response to this noisier environment.

## FSB leadership change heralds new world vision

The changing of the guard at the Financial Stability Board (FSB) is one example of a changing remit. In November 2018, the US Federal Reserve regulatory chief, Randal Quarles became its new chairman, replacing Mark Carney of the Bank of England. The new vice chairman is former Dutch central bank president, Klaas Knot.

As we noted in last year's report (EAMR 2018<sup>1</sup>), the US Treasury believed the FSB had gone beyond its mission of enhancing global financial stability and had not followed best practice in consultation and cost benefit analysis.

On his appointment, Quarles released a statement, saying "... the FSB has played a central coordinating role in building a resilient global financial system in the aftermath of the financial crisis. Ten years on, the FSB's work remains just as relevant." He also noted that coordination across different countries is needed for governments to react to crises.

“ ... new policies are being developed to address new risks to financial stability. ”

"Randy and Klaas will provide strong leadership and continuity as the FSB pivots towards the implementation and evaluation of post-crisis reforms, and to addressing emerging vulnerabilities in the global financial system," Carney said, after the announcement of the FSB appointments.

Carney had hinted at this new agenda in a letter<sup>2</sup> to G20 leaders in November 2018, writing as outgoing head of the FSB. Talking about the post-financial crisis reforms, Carney said: "The FSB is pivoting to focus on implementing those reforms, evaluating their effectiveness, and adjusting them where necessary. In parallel, new policies are being developed to address new risks to financial stability.

"G20 post-crisis reforms have delivered a safer, simpler and fairer financial system. To reinforce this progress, the FSB is working with standard-setters to complete work on a few final policy areas and focus on the implementation of the agreed financial reforms," his letter added.

Specifically, the new FSB agenda includes:

- Finalizing and operationalizing post-crisis reforms
- Monitoring their implementation

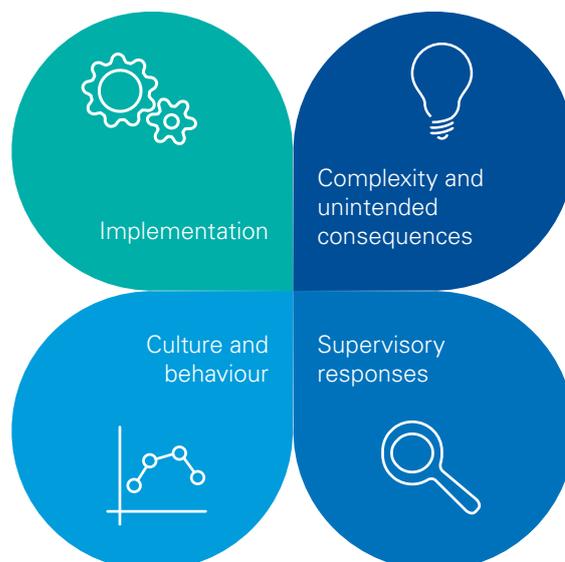
- Evaluating their effects and adjusting them where necessary
- Addressing new and emerging vulnerabilities in the financial system

This agenda will be challenging to carry out in practice. Some post-crisis international standards remain way off completion in some sectors (e.g. the development of an international capital standard for insurers). The timing and substance of the implementation of international standards is uneven across jurisdictions. Evaluations of post-crisis reforms have resulted in little adjustment to standards.

Also, there is a long list of areas where the FSB may develop further reforms, including: systemic risks arising from non-bank finance and, in particular, the structural vulnerabilities associated with asset management; cyber security; risks to financial stability arising from fintech; and climate change. (See Chapters 2, 6 and 7.)

The FSB is reviewing its processes and transparency. During 2018 it identified measures that need improvement, including: enhancing processes for policy prioritization and developing future work programs; further enhancing the efficiency of senior-level meetings and the work processes of working groups and work streams; and actions to improve communication and engagement with external stakeholders.

IOSCO – the International Organization of Securities Commission – is also responding to external voices.



<sup>1</sup> <https://assets.kpmg/content/dam/kpmg/nl/pdf/2018/advisory/evolving-asset-management-regulation-report.pdf>

<sup>2</sup> <http://www.fsb.org/2018/11/fsb-chairs-letter-to-g20-leaders-meeting-in-buenos-aires/>

## IOSCO's first annual work program

To enhance its effectiveness and the impact of its policy work on global securities markets, IOSCO's board published in March 2019 its first annual work program,<sup>3</sup> which highlights five priority issues for 2019:

- Cryptoassets
- Artificial intelligence and machine learning
- Market fragmentation
- Passive investing and index providers
- Retail distribution and digitalization

The program also includes work on/reviews of:

- Measures of leverage in investment funds
- Possible market liquidity impacts of exchange-traded funds (ETFs) and high frequency trading
- Practical "use case" applications of distributed ledger technology in securities markets
- The benefits and challenges of adopting machine-readable rule books
- National regulators' experiences in designing innovation support frameworks (such as sandboxes)
- Suitability requirements for complex financial products
- Business continuity plans for intermediaries and trading venues
- Money market fund and securitization reforms

## Demands of civil society, and trust

The public is more than ever an influencing factor in how regulators operate in 2019. A number of financial services scandals worldwide, combined with the huge growth in social media, has created a new constituency of concerned, and sometimes angry, consumers.

Nowhere is this truer than in **Australia** where the report by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was finally published in February 2019.<sup>4</sup> The Australian Government has signaled that restoring public trust in financial institutions will be one of its guiding principles in responding to the recommendations.

In the wake of the final report, there will be a plethora of new and strengthened regulations and requirements, and shifts in responsibility between regulators, with shared

duties in some areas. APRA<sup>5</sup> and ASIC<sup>6</sup> will be more vigilant and aggressive – ASIC has signaled an "if not, why not" stance – and the regulators' effectiveness will be monitored more closely. Major changes are also likely in the wealth, superannuation and insurance sectors, and individual accountability will extend to other areas of the financial services sector (see Chapter 3).

In the **UK**, a new duty of care rule is being considered (see Chapter 3). And the debates on costs and charges in many jurisdictions are another example of the power of external voices (see Chapter 4).

It will be interesting to see how the nature of regulatory debates plays out in the **EU**, given the composition of the new European Parliament. We also await the tone that will be set by the new Commission Presidency and the appointment of the Commissioner responsible for financial services. Will there be an increased focus on consumer protection and social objectives such as climate change and diversity? And how will EU regulation be adapted to accommodate the digital age?



Will there be an increased focus on consumer protection and social objectives such as climate change and diversity?



## National supervision broadens, deepens

Many national regulators are also reflecting on their roles amid the noise from external voices. Some governments are making wholesale changes to their regulatory structures. In other jurisdictions, supervisors are adopting subtler changes in stance which are no less important.

In **South Africa**, the long-awaited implementation of the "Twin Peaks" model – the Prudential Authority and the Financial Sector Conduct Authority – finally took place in 2018 and started to operate fully in 2019.<sup>7</sup> The model was driven by poor practices in the financial sector coupled with inadequate regulatory oversight.

It seeks to improve outcomes by placing equal and dedicated focus on managing key risks in the financial sector, with the South African Reserve Bank also having a mandate for overseeing the stability of the financial sector. The model is designed to create regulatory consistency, jurisdictional clarity and informational efficiency, while better addressing the inherent conflicts between prudential regulation and consumer protection.

<sup>3</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD625.pdf>

<sup>4</sup> <https://financialservices.royalcommission.gov.au/Pages/default.aspx>

<sup>5</sup> Australian Prudential Regulatory Authority

<sup>6</sup> Australian Securities and Investments Commission

<sup>7</sup> <http://www.treasury.gov.za/twinpeaks/CoFI%20Bill%20policy%20paper.pdf>

In **Canada**, progress is still being made towards creating a national securities regulator to unify the existing patchwork of provincial regulation of capital markets. There remains considerable divergence in the views of provincial regulators on how this might work, and it is possible that some provinces will opt to stay outside a federal regulatory framework.

In **Poland**, major regulatory reform is taking place. The Capital Market Development Strategy (Strategia Rozwoju Rynku Kapitałowego, or SRRK) was open for public consultation until March 21 2019. The SRRK was drafted with support of the EBRD<sup>8</sup> and the European Commission. It is part of wider plans to encourage Poland's economic development and transform the country into a regional economic leader.

The draft sets out two primary goals for the Polish capital market: to break down the barriers preventing accessible finance and to develop infrastructure that will allow for more agile market development and innovation. The SRRK follows the authorities' commitment to develop the local capital market, highlights the enormous potential that a market opening could have on the country's economy and envisages a role for investment funds in the development.

The extension of their powers and reach is prompting some regulators to demand more financial support from the investment industry. The Central Bank of **Ireland** (CBI), for instance, from January 2019 applied an additional supervisory levy<sup>9</sup> to asset managers, AIFMs<sup>10</sup> and UCITS<sup>11</sup> management companies. The levy is additional to the existing CBI annual industry funding levy that already applies to investment firms.

In **Japan**, the JFSA<sup>12</sup> is changing its approach rather than its structure. It is moving towards function-based, cross-sectoral regulations. The Study Group on the financial system, operating under the umbrella of the Financial System Council, is discussing a shift from an entity-based regulatory framework to a function-based, cross-sectoral regulatory framework.

The same regulations will apply to activities with the same functions and risks, with attention on the balance between innovation and consumer protection. It will be necessary, the group said, to devise a regulatory framework to recognize and measure differences in the nature and risks of each function and adjust rules accordingly.

Also in the latter camp is the **US SEC**,<sup>13</sup> whose tone towards the investment industry is changing markedly. It is signaling a desire to be more inclusive and to listen to industry.

<sup>8</sup> European Bank for Reconstruction and Development

<sup>9</sup> <https://www.centralbank.ie/regulation/markets-update/article/markets-update-issue-16-2018/central-bank-of-ireland/additional-supervisory-levy-asset-management-firms>

<sup>10</sup> alternative investment fund manager

<sup>11</sup> undertaking for collective investment in transferable securities

<sup>12</sup> Japanese Financial Services Agency

<sup>13</sup> Securities and Exchanges Commission



The new SEC tone was expressed clearly by its Director of Investment Management, Dalia Blass, who opened a speech<sup>14</sup> in October 2018 by quoting Atticus Finch, the attorney in the novel *To Kill a Mockingbird*: “you never really understand a person until you consider things from his point of view.” “My team and I have sought to understand the perspectives of investors, directors and other market participants so we are well-informed when thinking about policy,” said Blass.

“

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”

In another speech,<sup>15</sup> Blass invited firms to help the SEC develop policy: “Throughout our work is a strong belief that outcomes improve with understanding. That means our approach to each project starts with engagement. I would like you (and anyone who reads this speech) to view it as an invitation to come tell us about your experience and ideas. We value and use that input.”

The SEC has backed its words with action: namely the Board Outreach Initiative, which aims to review the rules and advice the SEC lays down for fund boards. The initiative will focus on the SEC’s priorities for fund management:

- Improving the retail investor experience
- Modernizing the regulatory framework and engagement
- Leveraging SEC resources efficiently

### Regulators get tech-savvy

Technology has emerged as a loud and insistent external voice. It is not only disrupting the investment industry, it is changing the way in which the industry is supervised, too.

Blass said the SEC would increasingly use data analysis in its oversight, disclosure and regulatory initiatives, and has developed new and simpler ways for investors to provide feedback on the proposals that directly affect them. These include a “feedback flier” that allows investors to submit comments without needing to review the entire rulemaking proposal or write a letter, and the new “Tell Us” website, which provides a portal for this feedback.



<sup>14</sup> <https://www.sec.gov/news/speech/speech-blass-101618>

<sup>15</sup> <https://www.sec.gov/news/speech/speech-blass-102518>

Given the growth in the private fund market in **Jersey** and in recognition of the wish to provide speed to market for new funds, the regulator has introduced a fully electronic process for private fund applications. This tool is part of the regulator's e-enablement strategy and lays the foundation for future online capabilities across the funds sector.

The **Luxembourg** CSSF<sup>16</sup> is developing artificial intelligence (AI) tools to improve its supervision activities. It said it was working with several market participants based in Luxembourg to test the use of AI and robotics. It is exploring how AI could be used to analyze documents submitted by asset managers, such as transaction data and risk management reports. AI could also speed up the fund approval process through the use of optical character recognition, where words are converted into machine-friendly code to enable documents to be read quickly by a computer.

**France** has launched a major modernization plan for the AMF,<sup>17</sup> which has been undertaking targeted recruitment to enhance relevant skills and expertise. Modernizing the AMF was the final priority of the Strategic Plan for 2018-2022.

During 2019, there will be an important first milestone for the AMF's new asset management information system (BIO 3), which will dematerialize exchanges of information between the AMF and fund management companies, while improving the security of these exchanges.<sup>18</sup> The AMF will continue to adapt its skills in data processing, cyber-risk management and analysis of the impact of global warming, via training programs and targeted recruitments.

Like the SEC, the AMF is repositioning itself as a "partner" to the investment industry. It aims to work more closely with individual firms rather than taking a broad brush approach to regulation. As announced in 2018 as part of its new #Supervision2022 strategy, the AMF publicized the main findings of its "SPOT" controls.<sup>19</sup> SPOT controls consist of shorter, focused and more numerous inspections conducted at the same time with several players on a specific topic.

One of the goals of these thematic inspections is to share key findings more widely and promote good practices among supervised firms. This includes understanding of MiFID II<sup>20</sup> sales process requirements, applicable to products sold to elderly people in particular, and valuation of holdings in target companies by private equity firms.

Meanwhile, the **Belgian** regulator has introduced electronic filing for the registration of foreign funds marketed to retail investors. And the **UK** Financial Conduct Authority (FCA) is introducing electronic registration of AIFs.

## The debate over ESMA's powers

In **Europe**, a heated debate over increased powers for the European Supervisory Authorities (ESAs) concluded in April 2019. The European Commission had proposed in September 2017<sup>21</sup> new governance, funding and powers for the ESAs – the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

In order to increase supervisory convergence within the bloc, it was originally proposed that ESMA should have the final say in the approval of arrangements by asset and fund managers to delegate or outsource a material part of their activities or key functions to a third country. ESMA was also set to take over the authorization of certain types of investment funds from the national regulators (national competent authorities, or NCAs).

Members of the European Council had opposing views on whether the ESAs should have these increased powers or whether the NCAs should retain responsibility, with ESMA more actively monitoring developments and making recommendations. The European Parliament backed an amendment that ESMA should be able only to issue recommendations on the verification procedures of NCAs for delegation arrangements, and not to second guess NCAs' decisions in individual cases.

### New or enhanced areas of focus or scope for the ESAs:

- EU-wide resilience assessments and stress tests
- Development of systemic risk measures and indicators of consumer harm
- The supervisory approach to the fitness and propriety of key function holders
- Extended product intervention powers
- Consideration of environmental, social and governance factors
- Cybersecurity and taking account of financial innovation

These themes run through Chapters 2 to 7.

The debate also became caught up in increased concerns about anti-money laundering (AML) supervision, over which the EBA will now have direct powers.

Aside from changes to its governance and powers, ESMA has a lengthy and intense program of work ahead, as indicated by its "Supervisory Convergence Work Programme" and "Risk Assessment Work Programme" for 2019. ESMA's recent publications demonstrate that its role is now more focused on supervisory convergence and market monitoring, having been preoccupied in recent years in writing "Level 2" rules, especially under MiFID II.

<sup>16</sup> Commission de Surveillance du Secteur Financier

<sup>17</sup> Autorité des Marchés Financiers

<sup>18</sup> [https://www.amf-france.org/en\\_US/Reglementation/Dossiers-thematiques/l-AMF/Plan-strategique-de-l-AMF/Priorites-2019-de-l-autorite-des-marches-financiers](https://www.amf-france.org/en_US/Reglementation/Dossiers-thematiques/l-AMF/Plan-strategique-de-l-AMF/Priorites-2019-de-l-autorite-des-marches-financiers)

<sup>19</sup> [https://www.amf-france.org/en\\_US/Publications/Controles-SPOT/synthese-spot-decembre-2018-valorisation-societes-non-cotees](https://www.amf-france.org/en_US/Publications/Controles-SPOT/synthese-spot-decembre-2018-valorisation-societes-non-cotees)

<sup>20</sup> EU Markets in Financial Instruments Directive, revised

<sup>21</sup> [https://ec.europa.eu/info/publications/170920-esas-review\\_en](https://ec.europa.eu/info/publications/170920-esas-review_en)

### ESMA's Supervisory Convergence Work Programme 2019 includes:



Ensuring supervisory convergence in the context of Brexit



Making data more robust by developing and clarifying methodologies



Driving consistency in the application of MiFID II/MiFIR<sup>22</sup> and reaching a common understanding of supervisory challenges



Safeguarding the free movement of services in the EU through adequate investor protection in cross-border business



Fostering supervisory convergence in financial innovation

### ESMA's Risk Assessment Work Programme for 2019 includes:



Working with national regulators to develop infrastructure for processing market data



Enhancing its risk monitoring capacities and publishing more statistical reports, including the first annual report on MiFID II data



Conducting in-depth analysis around key topics, including market and investment fund liquidity, fund leverage, and the impact of innovation on market infrastructures and investment advice



Enhancing stress-testing, including for investment funds, and more sophisticated EU-wide tests on central counterparties.

## National regulators demand a pause

Sometimes voices are seeking inaction rather than action. The asset management industry and its clients have long asked regulators to take a break from new rule-making after the deluge of new regulation in the post-financial crisis era. It seems that regulators now agree.



... the best way to avoid a damaging cycle of deregulation, crisis and regulation is to keep an open mind about the shortcomings of existing rules



The **UK** FCA, for one, signaled a major shift in its approach to the fund industry. In October 2018, in his first speech<sup>23</sup> since taking over as chair of the FCA, Charles Randell said it was time to slow down on new rules and evaluate the effectiveness and consequences of regulations over the past 10 years.

In the speech, Randell said the best way to avoid a damaging cycle of deregulation, crisis and regulation is to keep an open mind about the shortcomings of existing rules. The FCA, he said, should have the humility to acknowledge that it does not always know best, as its past decisions show. It should ensure that the program of regulatory change is phased and coordinated in a proportionate way.

Also in October 2018, the chair of the AMF said regulators should target convergence of regulatory guidance. Robert Ophèle said, "There is a clear need for genuine supervisory convergence in order to guarantee a level playing field."<sup>24</sup> He called for national regulators to be consulted when a topic in a Q&A is "material".

## Post-regulatory reviews – a new direction?

As we have seen, many regulators are refocusing their aims and resources. This includes stepping back from making new rules and moving on to the business of reviewing the implementation and impact of post-crisis reforms.

The differing review timelines set by **EU** legislation give rise to the question of whether there is scope to review EU post-crisis regulation in the round and understand its collective impact on the industry, regulators and consumers. The **US** Treasury did just that – see EAMR 2018.

In relation to the AIFMD<sup>25</sup> and the UCITS Directive, the Commission has been adopting a common approach to reviews. In 2018 it issued two proposals to amend and align both directives – one on removing remaining national barriers to the cross-border distribution of funds; the other on the asset segregation provisions for fund depositories. Both proposals have been adopted by the European Parliament and the Council.

In contrast, the industry is contending with different and conflicting disclosure requirements under the PRIIP KID,<sup>26</sup> MiFID II and the IDD<sup>27</sup> (see Chapter 4).

<sup>22</sup> EU Markets in Financial Instruments Regulation

<sup>23</sup> <https://www.fca.org.uk/news/speeches/rolling-rock-cycle-deregulation-crisis-and-regulation>

<sup>24</sup> [https://www.amf-france.org/en\\_US/Actualites/Prises-de-paroles/Archives/Annee-2016?docId=workspace%3A%2F%2FSpacesStore%2Fac5c4822-fd35-4764-8e22-2e940d86266d](https://www.amf-france.org/en_US/Actualites/Prises-de-paroles/Archives/Annee-2016?docId=workspace%3A%2F%2FSpacesStore%2Fac5c4822-fd35-4764-8e22-2e940d86266d)

<sup>25</sup> EU Alternative Investment Fund Managers Directive

<sup>26</sup> EU packaged retail investment and insurance-based products, key information document

<sup>27</sup> EU Insurance Distribution Directive

The future EU direction of travel may not become clear until after the new European Parliament and Commissioners are fully bedded in, but work has already started. The European Commission engaged KPMG<sup>28</sup> to report on whether the AIFMD's objectives have been met, by assessing a number of the AIFMD requirements against five principles: effectiveness, efficiency, coherence, relevance and EU added value.

The report<sup>29</sup> found that AIFMD has played a major role in helping to create an internal market for AIFs and a harmonized and stringent regulatory and supervisory framework for AIFMs. However, there are aspects that have not contributed, or may be counter, to the achievement of these aims – particularly in relation to effectiveness and efficiency.

There was an over-riding concern that AIFMD implementation had been costly for both firms and regulators, with limited added value for investors. Another finding was that a large majority of institutional investors taking part in the report said that AIFMD had not influenced their decisions to invest through AIFs, or to invest through EU/EEA AIFs rather than third-country AIFs (or vice versa).

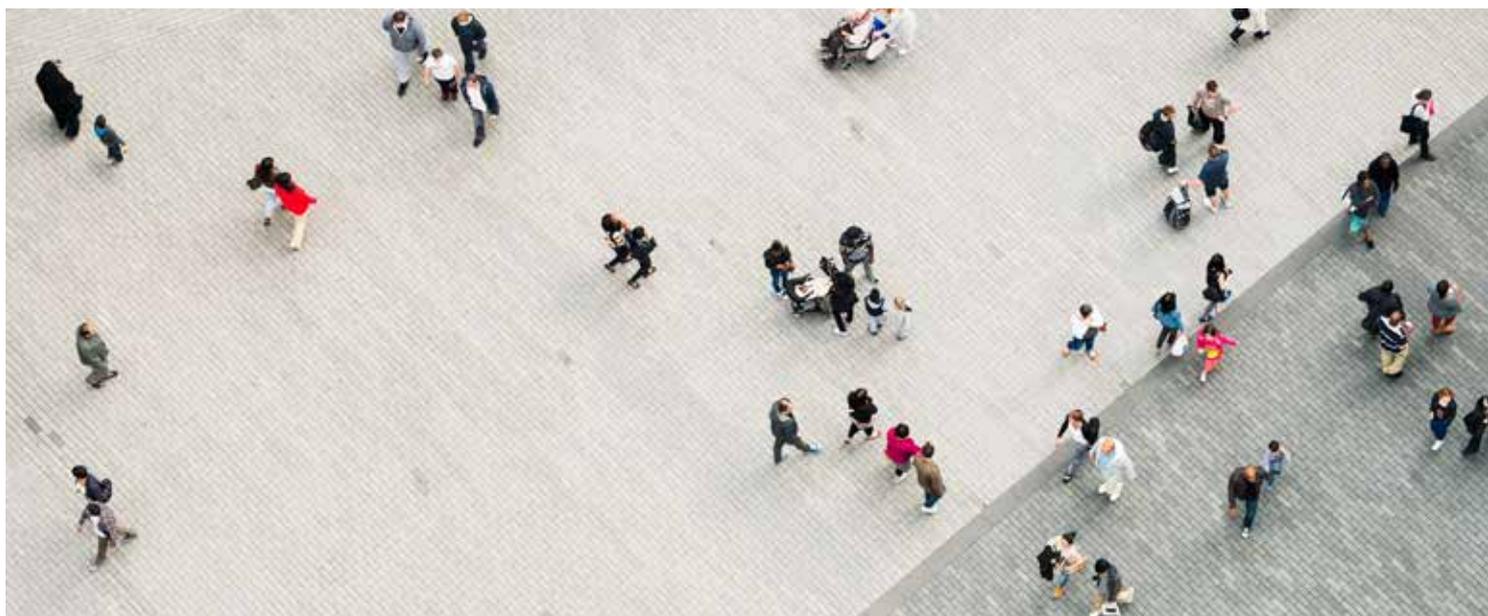
The Commission described KPMG's report as the "first step" in the process of reviewing the directive. It seems unlikely that we will see anything further until later this year after the Commissioner is appointed, or early 2020. The Commission may look at the reporting requirements and the calculation of leverage, but it is not clear what else will be on its agenda. Indeed, having already issued amendments on cross border marketing and asset segregation, it may not have an appetite for major change on other points.

For the Commission one of the big questions is if and how it can make Capital Markets Union (CMU) work. Certainly, the proportion of funds registered for sale in more than three member states is low, at 37 percent for UCITS and just 3 percent for AIFs. But Valdis Dombrovskis, the EU Commissioner for Financial Stability, Financial Services and the Capital Markets Union, said the Commission needed more time to implement CMU.

The AMF issued its own study on the **French** AIF market based on reports from AIFMs.<sup>30</sup> It gave a first insight into French AIFs' exposures, liquidity risk and leverage, and included proposals on how data could be better analyzed to build synthetic indicators for risk monitoring purposes. It also highlighted some areas where the reporting as it stands does not provide meaningful information – in relation to investment strategy, for instance.

Data collection is up for review in other jurisdictions, too. In the **US**, CFTC<sup>31</sup> Commissioner Dawn Stump launched an effort to evaluate and improve the way personal information is collected. Stump said the CFTC would investigate whether it is only collecting the data it needs and whether its procedures are tough enough to withstand increasingly sophisticated cyberattacks. It is considering the personally identifiable information it gathers as well as data collected on trading transactions, positions and strategies.

In **Canada** there is a move towards "regulatory reduction", or a review of existing regulations with a view to streamlining them. Many existing rules were made when derivatives were barely used in the industry, so the review reflects modernization as well as streamlining aims.



<sup>28</sup> A cross-service team composed of specialists from KPMG Law and KPMG in Germany, KPMG in the UK and KPMG in France

<sup>29</sup> [https://ec.europa.eu/info/sites/info/files/business\\_economy\\_euro/banking\\_and\\_finance/documents/190110-aifmd-operation-report\\_en.pdf](https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/190110-aifmd-operation-report_en.pdf)

<sup>30</sup> [https://www.amf-france.org/en\\_US/Actualites/Communiqués-de-presse/AMF/annee-2019?docId=workspace%3A%2F%2FSpacesStore%2F6c171e6-9bae-4c1f-b355-b9a4bf7c6a64&langSwitch=true](https://www.amf-france.org/en_US/Actualites/Communiqués-de-presse/AMF/annee-2019?docId=workspace%3A%2F%2FSpacesStore%2F6c171e6-9bae-4c1f-b355-b9a4bf7c6a64&langSwitch=true)

<sup>31</sup> Commodity Futures Trading Commission



One direction of travel, as set out by the Ontario regulator,<sup>32</sup> is towards cost-benefit analysis in all new regulation. Because post-financial crisis regulation was made with speed, many rules were simply imported, wholesale, from other jurisdictions. In particular, the regulator will identify opportunities to reduce or eliminate redundant or unnecessary non-investment fund reporting, issuer disclosure or other requirements where current requirements are not achieving desired regulatory outcomes.

## The MiFID II fallout begins

MiFID II is the next recently-implemented piece of EU regulation to fall under the microscope. One of the most challenging raft of rules ever to hit the EU asset management industry is now being reassessed as the ramifications become clearer.

The **UK** FCA is carrying out an investigation into how MiFID II has impacted investment research, amid concerns it is being interpreted in different ways by different firms. The rules demand that asset managers separate the fees for research from execution costs – called “unbundling”. Managers must pay for research themselves or agree a budget with their clients.

As part of its investigation, which started in late 2018 and took around six months, the FCA contacted banks, brokers and independent providers as well as asset managers on how research is being priced now the directive has come into force, with the aim of uncovering unusual methodologies. The regulator also examined whether asset managers are charged for face-to-face meetings with investee companies by brokers and banks.

According to a survey published in February 2019,<sup>33</sup> carried out by polling firm YouGov for broker Peel Hunt and the Quoted Companies Alliance, more than half of UK asset managers believe their access to research providers has been curtailed. Over 60 percent believe there is less research being produced on small and mid-caps, with a similar proportion saying the changes have caused a fall in liquidity for small-caps.

The **French** financial regulator also launched a probe into MiFID II research practices. Natasha Cazenave, Managing Director of Policy and International Affairs at the AMF, said assessing the impact was a “priority” for the regulator.<sup>34</sup> The AMF examined how the rules have impacted the funding of investment research, both in France and across Europe. Cazenave said French asset managers may have an advantage. In contrast to the UK, for example, they are mostly UCITS management companies or AIFMs. The MiFID II rules do not automatically apply to them and the AMF has left it to firms’ discretion whether they chose to follow the rules.

<sup>32</sup> [https://www.osc.gov.on.ca/documents/en/Publications/Publications\\_rpt\\_2018\\_osc-annual-rpt\\_en.pdf](https://www.osc.gov.on.ca/documents/en/Publications/Publications_rpt_2018_osc-annual-rpt_en.pdf)

<sup>33</sup> [https://www.peelhunt.com/insights/the\\_search\\_for\\_research](https://www.peelhunt.com/insights/the_search_for_research)

<sup>34</sup> [https://www.amf-france.org/en\\_US/Actualites/Prises-de-paroles/Archives/Annee-2016](https://www.amf-france.org/en_US/Actualites/Prises-de-paroles/Archives/Annee-2016)

The revised MiFID rules favor larger asset managers, according to a survey by the Chartered Financial Analyst Institute (CFAI) of European investment professionals.<sup>35</sup> Investment firms have slashed their research budgets by 6.3 percent on average. But budget cuts depend on the size of firms and smaller managers have reduced their budgets by 11 percent on average.

The CFAI said the disparity in the budget reductions may “allude to the ease with which a firm can substitute externally procured research for in-house research.” The CFAI added there was “little evidence” of asset managers increasing their management fees to compensate for absorbing the cost of investment analysis.

**German** firms complain that the quality of financial advice has not improved as a result of MiFID II, according to a survey.<sup>36</sup> A poll by Frankfurt-based consultancy Cofinpro of 57 German banks and fund houses showed that MiFID II has had “primarily negative repercussions.” Nearly three-quarters of respondents said financial products were not cheaper or better tailored to investors’ needs. More than half said that fund sales had fallen. Over half also said that the restrictions had resulted in fewer choices for investors. Several German banks have reportedly withdrawn from the advice market altogether. Smaller banks in particular said they were overwhelmed by the costs of the directive.

In September 2018, the German Ministry for Economic Affairs and Energy published its overhauled Finanzanlagenvermittlungsverordnung, which allows intermediaries to continue to be able to accept inducements without having to use them to improve the quality of advice they provide. The clamor for change led the German Federal Ministry of Finance to consult on MiFID II/MiFIR.<sup>37</sup> The objective of the consultation, which ended in March 2019, was to get a sense of the day-to-day experience of financial institutions operating under the new rules.

For the investment industry across the **EU**, innovative performance-related fees are being hindered by MiFID II, according to some investment firms. Under MiFID II, costs and charges must be shown on both an ex-ante, or forward-looking, and an ex-post basis, showing what was charged over the past year. It is not possible to predict performance-related fees before they are levied, it is argued.

On a more positive note, MiFID II was found to drive fund platform growth across the EU. According to consultancy Platform, Europe’s 10 largest fund platforms combined had asset growth of 19 percent in the wake of MiFID II.

## Meanwhile, MiFID II’s tenets spread

In **Switzerland**, two new laws entered into force on 1 January 2020 – the Financial Services Act (FinSA) and the Financial Institutions Act (FinIA) – which have significant implications for the Swiss funds and asset management industry. The two laws have the common aim of strengthening consumer protection, creating a level playing field for financial institutions and, not least, aligning Swiss laws with MiFID II/MiFIR and the EU Prospectus Directive.<sup>38</sup>

FinSA regulates the provision of financial services and offering of financial instruments, while FinIA sets out the licensing requirements for regulated financial institutions other than banks, including asset managers and fund management companies. Independent asset managers will now be subject to FINMA<sup>39</sup> authorization and to rules on capital, risk management and internal controls.

FinSA introduces a new client classification regime that is not fully aligned with MiFID II. In both jurisdictions, high-net-worth retail clients are or will be able to opt out of retail client protection and choose to be treated as professional clients if they have specialist knowledge. FinSA goes further, by allowing an opt-out if the client has sufficient assets, regardless of knowledge and experience.

There are calls for the **US** SEC to enhance its requirements on broker-dealer fee disclosures in line with MiFID II (see Chapter 3), and it has been urged by asset managers and institutional investors to align its regulations on investment research. MiFID II clashes with the US “soft dollar” rule that requires a US business that sells research for “hard” dollars to be a registered investment adviser, increasing compliance obligations. US regulations therefore make unbundling difficult for local brokers. Asset managers have found ways to navigate these restrictions, such as by continuing to pay bundled commissions but reimbursing research costs to clients.

The difference between the regimes led to the SEC issuing a 30-month delay for US banks and brokers to charge EU asset managers’ clients for research. This is unusual: the SEC has in the past resisted changes to its rules based on changes in other jurisdictions. The SEC will decide whether to extend the delay beyond July 2020.

Some US managers have voluntarily signed up to the MiFID II investment research rules across their worldwide operations. Trading venue Liquidnet issued a report in December 2018 which showed that more than half of asset managers had unbundled research fees and execution costs as a global policy, and a further 20 percent planned to do so within five years.<sup>40</sup>

<sup>35</sup> <https://www.cfainstitute.org/en/about/press-releases/2019/analyst-jobs-and-research-budgets-cut-as-mifid-ii-takes-hold>

<sup>36</sup> <https://www.fondsprofessionell.de/news/recht/headline/mifid-ii-bafin-erklaert-details-zur-geeignetheitserklaerung-146777/newsseite/6/uebersichtseite/1/newsbild/2/>

<sup>37</sup> [https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze\\_Gesetzesvorhaben/Abteilungen/Abteilung\\_VII/19\\_Legislaturperiode/Konsultationen-zur-EU-Finanzmarkttrichtlinie.html](https://www.bundesfinanzministerium.de/Content/DE/Gesetzestexte/Gesetze_Gesetzesvorhaben/Abteilungen/Abteilung_VII/19_Legislaturperiode/Konsultationen-zur-EU-Finanzmarkttrichtlinie.html)

<sup>38</sup> <https://publications.europa.eu/en/publication-detail/-/publication/427a4786-5fbc-449d-b411-1acc5c095004/language-en>

<sup>39</sup> Financial Market Supervisory Authority

<sup>40</sup> <https://www.liquidnet.com/expert-insights/unbundling-research-canary-in-the-coalmine>



## Chapter 2

# Systemic risk: conflicting voices

The identification and containment of systemic risks became the overwhelming priority of policy-makers and regulators after the 2008 financial crisis.

Eleven years on, the financial crisis is now a distant memory for many, but policymakers are still highly attuned to the fragility of markets. They are keen to avoid a new crisis under their watch.

As the asset management industry expands, so debate around it intensifies. Regulators are deepening their examination of systemic risks in the asset management sector, with a focus on liquidity and leverage. The increasing size of the industry is stimulating new policy debates.

<sup>41</sup> [http://www.fsb.org/2019/02/fsb-publishes-global-monitoring-report-on-non-bank-financial-intermediation-2018/?utm\\_source=POLITICO.EU&utm\\_campaign=d0c43f9fa0-](http://www.fsb.org/2019/02/fsb-publishes-global-monitoring-report-on-non-bank-financial-intermediation-2018/?utm_source=POLITICO.EU&utm_campaign=d0c43f9fa0-)

<sup>42</sup> <https://www.esrb.europa.eu/news/pr/date/2018/html/esrb.pr180910.en.html>

## Global and regional policy-makers highlight risks

The FSB stepped back into the systemic risk debate in February 2019,<sup>41</sup> arguing that regulators should pay more attention to risks given the record level of assets under management and the consequent risk posed by a sudden surge in redemptions. It said the sector had overtaken insurers, banks and pension funds to reach USD 116.6 trillion in assets worldwide. It moved away from the term “shadow banking”, preferring instead the term “non-bank financial intermediation”.

The **European** Systemic Risk Board (ESRB) reported in September 2018<sup>42</sup> that the shadow banking system – a term it persists in using and which it defines as all financial sector assets except those of banks, insurers, pension funds and central counterparties – represents assets of about EUR 42 trillion, or around 40 percent of the total EU financial system.

The report noted a range of risks and vulnerabilities, including those related to interconnectedness, liquidity and leverage. It highlighted potential liquidity risks and market functioning implications of exchange-traded products (ETPs) and ETFs, and that 7 percent of UCITS use credit default swaps. It did not identify new risks, but said that data gaps prevented a more comprehensive risk assessment.

The European Central Bank (ECB) also persists with use of the term “shadow banking”. In September 2018, President Mario Draghi said that the next step for the rapidly-growing sector is greater scrutiny and macro-prudential measures.<sup>43</sup>

In April 2019, the ESAs published their latest report<sup>44</sup> into risks in the EU financial system. They identified two key areas of risks to financial stability of direct relevance to asset managers: activities and uncertainties around the UK’s withdrawal from the EU (Brexit); and asset valuations in a less favorable macroeconomic environment.

The **US** Financial Stability Oversight Council is also focussing on activities. It consulted until May 2019 on revised interpretative guidance. The Council will pursue entity-specific determinations only if a potential risk cannot be addressed through an activities-based approach.

### Data, data, data

A common and long-standing thread in the statements of policy-makers and regulators is the need for more and better data. The reporting requirements on asset managers and funds has multiplied since the crisis, but policy-makers are still data hungry.

The scope of specified derivatives contracts to be reported has been extended in **Singapore**, for example. Asset managers, whose aggregate gross notional amount of specified derivative contracts exceed SGD 5 billion for the



The reporting requirements on asset managers and funds has multiplied since the crisis, but policy-makers are still data hungry.



four most recently completed quarters, are required to report interest rate and credit derivatives contracts traded in Singapore from October 2019, and foreign exchange, equity and commodity derivatives contracts booked or traded in Singapore from October 2020.<sup>45</sup>

In **Belgium**, fund managers could soon be subject to additional reporting requirements. The National Bank of Belgium and the Financial Services and Markets Authority issued in October 2018 an updated report on asset management and “shadow banking” in Belgium, estimated at EUR 14.7 billion at the end of 2017.<sup>46</sup> No substantial systemic risks were identified in relation to asset management and non-bank financial intermediation, but monitoring will continue.

In other areas there is a question whether the data already collected are too voluminous and insufficiently focused on the right issues. The EU AIFMD reporting requirements are a case in point.

### KPMG findings on AIFMD reporting

Large volumes of data are submitted by AIFMs to NCAs under the AIFMD reporting requirements, but not all the data are essential, some are insufficient and some are duplicative.<sup>29</sup> There are also overlapping reporting obligations with other EU legislation.

Survey data indicate that high leverage is rare in AIFs. It would be helpful to harmonize the calculation methodologies for leverage across AIFMD, the UCITS Directive and other relevant legislation, taking into consideration the recent recommendations of IOSCO.

The extent of the notifications to NCAs under the rules for investments in non-listed companies is viewed as not useful or essential, and overly burdensome (especially given that many private equity/venture capital AIFMs are smaller companies, for whom the administrative burdens may be proportionately greater).

<sup>43</sup> [https://www.ecb.europa.eu/pub/pdf/annex/ecb.sp180924\\_2\\_transcript\\_en.pdf?8799c0f54287a4943627f4a8524de757](https://www.ecb.europa.eu/pub/pdf/annex/ecb.sp180924_2_transcript_en.pdf?8799c0f54287a4943627f4a8524de757)

<sup>44</sup> <https://eba.europa.eu/documents/10180/2551996/Joint+Committee+Report+on+risk+and+vulnerabilities+in+the+EU+financial+system++Spring+2019+.pdf>

<sup>45</sup> <http://www.mas.gov.sg/~media/MAS/News%20and%20Publications/Consultation%20Papers/Consultation%20Paper%20on%20Proposed%20Amendments%20to%20the%20SFR-reporting%20of%20Derivatives%20Contracts-Regulations.pdf>

<sup>46</sup> <https://www.nbb.be/en/articles/update-nbb-and-fsma-asset-management-and-shadow-banking-belgium>

## The systemic risk spotlight turns to leverage

After FSB recommendations in 2017<sup>47</sup> on structural vulnerabilities in asset management, IOSCO consulted until February 2019 on a standardized set of measures for leverage and a proposed supervisory framework.<sup>48</sup> The paper uses the generic term “investment fund” and referred in places to AIFMD, implying that both mutual funds and AIFs are within scope. Separately-managed portfolios or accounts – such as defined benefit pension funds – were not mentioned.

IOSCO said rules on leverage in funds, and their measurement and monitoring, vary around the globe. Even where regulators require reporting of leverage data (notably, in the **EU** and the **US**), different metrics are used, which creates challenges for the monitoring of potential systemic risks at global level. Comparability is also hampered by the wide variety of funds and investment strategies.

IOSCO acknowledged the challenge of achieving precise leverage measures while producing sufficiently simple, robust metrics that can be applied in a consistent manner to the wide range of funds offered in different jurisdictions and still be informative. It also recognized that derivatives should not be seen as solely synonymous with the amplification of risk and returns but can equally reflect the use of hedging and cost-efficiency techniques.

It therefore proposed a flexible two-step approach: an initial filter applied to all funds, then a risk-based analysis of a subset of funds. Step one, the initial filter, will exclude funds that are unlikely to pose risks to the financial system, allowing regulators to focus their attention at step two on potentially riskier funds. IOSCO does not intend to prescribe metrics for either step one or step two, believing that each jurisdiction should determine the most appropriate risk assessment give the type and nature of the funds under review.

This flexible approach will accommodate the wide range of legal structures, strategies, asset classes and portfolio compositions used by funds, but it raises the question whether it will lead to improved comparability at global level. Fund managers might still need to produce a number of different reports and to perform different calculations for similar funds, which will result in additional operational costs and added complexity for investors seeking to compare funds.

Within the EU, it is not clear how a consistent analytical framework for the second stage analysis will recognize the very different national markets. It is therefore not certain that the end result will be increased comparability of funds for investors or reduced operational costs for managers.



Fund managers might still need to produce a number of different reports and to perform different calculations for similar funds,



Moreover, the ESRB called in 2018 for greater use of leverage limits, which could restrict professional investors’ investment options in EU-domiciled funds.<sup>49</sup> Under AIFMD, ESMA and the NCAs are allowed to impose macro-prudential limits on the level of leverage in funds, but this provision has not yet been employed. As noted in Chapter 1, ESMA’s work program includes work on measures of leverage in funds.

Elsewhere around the globe, regulators are responding to IOSCO’s recommendations. In **Kuwait**, for example, new requirements on leverage were introduced for investment funds in 2016 but similar requirements are now being introduced for asset managers of separately-managed accounts.

## Liquidity risks not forgotten though

The Monetary Authority of **Singapore** (MAS) issued in August 2018 guidelines on liquidity risk management for fund management companies.<sup>50</sup> MAS recognized that fund managers employ different fund structures and that, where an open-ended fund allows redemption on a regular basis with little or no advance notice, it is prudent for the fund manager to put in place effective liquidity risk management frameworks and practices to ensure that it is able to manage redemption requests in a timely and orderly manner.

The key components of the liquidity risk management framework cover:

- A liquidity risk management function, subject to effective oversight
- When designing the product, evaluation of the liquidity risks that the fund may face and alignment of the dealing arrangement with investors’ expectations and the fund’s investment strategy and liquidity profile
- Monitoring and managing liquidity risks on an ongoing basis to anticipate an emerging liquidity issue and mitigate its impact
- Regular stress testing based on historical market conditions and forward-looking hypothetical scenarios

<sup>47</sup> <http://www.fsb.org/2017/01/policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/>

<sup>48</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCO615.pdf>

<sup>49</sup> <https://www.esrb.europa.eu/news/pr/date/2018/html/esrb.pr180214.en.html>

<sup>50</sup> <http://www.mas.gov.sg/~media/MAS/Regulations%20and%20Financial%20Stability/Regulations%20Guidance%20and%20Licensing/Securities%20Futures%20and%20Fund%20Management/ID%20Guidelines/Guidelines%20on%20Liquidity%20Risk%20Management%20Practices%20for%20Fund%20Management%20Companies.pdf>

As noted in EAMR 2018, earlier in 2018 the ESRB recommended that existing ESMA guidance on liquidity and leverage risks for **EU** funds should be enhanced to include:

- The design of liquidity stress testing (LST) scenarios
- An LST policy and internal use of LST results
- Considerations for the asset and liability sides of investment fund balance sheets
- The timing of and frequency for individual funds to conduct LST

In December 2018, the ECB re-entered the debate. Luis de Guindos, ECB vice-president said there were growing signs of a potential liquidity squeeze in the industry and that regulation should be enacted at regional level because a crisis in one EU member state could have repercussions on all the others.<sup>51</sup>

Subsequently, ESMA consulted until April 2019 on 14 principles-based guidelines for EU fund management companies and depositaries, relating to existing UCITS and AIFMD requirements. It is expected to publish feedback in Q2 2019 and produce a final report in mid-2019. ESMA said liquidity risk in investment funds has crystallized infrequently and has largely been contained, but an event could have a considerable impact on investors. LST is only one tool in managing fund liquidity, which the great majority of fund managers already employ.

The guidelines recognize that a variety of methods can be used to build LST models and do not adopt a one-size-fits-all approach. They cover all UCITS and AIFs, including money market funds (MMFs), ETFs and leveraged closed-ended AIFs. Industry commentators have expressed concern, though, about whether there is sufficient data available across all asset markets.

## National systemic risk measures

**Belgian** fund managers will have a wider set of liquidity management tools, following the joint report of the central bank and the regulator, mentioned above.

In its neighbor, the **Netherlands**, the Dutch National Bank and the AFM,<sup>52</sup> carried out a study into the liquidity risk management by Dutch AIFMs to understand potential vulnerabilities from liquidity mismatches. The study found that some funds do not have emergency liquidity management tools, such as using gates or side pockets, or even suspending redemptions, in volatile markets.



<sup>51</sup> <https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp181214.en.html>

<sup>52</sup> Authority for the Financial Markets

A study by the **Spanish** regulator, the CNMV<sup>53</sup> found that at the height of the eurozone sovereign wealth crisis, Spanish investment funds were “highly resilient”. The regulator was concerned, though, that low interest rates had driven fund managers to seek out higher returns by acquiring fixed income assets with lower liquidity, longer duration and higher credit risk.<sup>54</sup>

A Royal Decree in December 2018 therefore gave the CNMV the power to be able to specify a minimum level of liquid assets in a fund. It will have the right to ask individual asset managers or the entire industry to increase the liquidity of the portfolios held by funds they manage. Another Royal Decree, in March 2019 created a macro-prudential entity, which will be responsible for preventing and mitigating systemic risk.



... if asset managers sell less liquid assets in large volumes and at reduced prices in order to meet redemption demands, there is a potential threat to stability and resilience.



In the **UAE**, changes to the DFSA's<sup>55</sup> Collective Investment Funds regime came into force in December 2018, strengthening its commitment to meeting international standards, particularly those of IOSCO and the FSB enhancing liquidity risk management in open-ended funds.<sup>56</sup>

In its annual review of the asset management industry, published in January 2019, the **UK** FCA identified five sector-wide issues, one of which related to the growth in less liquid assets in investment funds.<sup>57</sup> The FCA noted that if asset managers sell less liquid assets in large volumes and at reduced prices in order to meet redemption demands, there is a potential threat to stability and resilience. It recognised, however, that investments in less liquid assets are only growing slowly.

The **French** authorities said that understanding and addressing macro-prudential risks is a key priority. The Haut Conseil pour la Stabilité Financière (the French macro-prudential authority) and the AMF released a study analyzing connections between the French collective portfolio management sector and the French financial system at large over the period 2008-2016.<sup>58</sup>

The AMF published a study entitled *Macro stress tests, what impact on markets and asset management?*<sup>59</sup> In this

paper, the AMF proposed a review and analysis of macro-stress tests in asset management as well as possible ways forward to support development.

In **Switzerland**, the industry body made a non-binding recommendation that collective investment schemes must ensure “expedient and appropriate” risk management, internal controls and compliance.<sup>60</sup> This is the first Swiss fund and asset management industry standard on the implementation of risk management requirements. It covers enterprise risks and investment risks, which include market, liquidity and counterparty risks.

## More on money market funds

Despite major post-crisis reforms to the rules governing MMFs, in particular in the **US** and the **EU**, regulation of this section of the industry continues to develop.

The EU Money Market Funds Regulation requires managers to conduct regular stress tests, identifying how stress events and changes in economic conditions can impact the net asset value (NAV) and liquidity of the funds. ESMA consulted until December 2018 on draft guidelines on internal stress testing of MMFs.<sup>61</sup> It noted that “while MMFs invest in highly liquid and low risk short-term debt instruments, they play an important role in the financial system and are interconnected with other key market participants.”

Views were sought in particular on ESMA's proposed methodology, risk factors, data and the impact calculation. It was the first step in developing detailed specifications for stress tests that take into account the following hypothetical risk factors:

- Liquidity changes of the assets held in the MMF's portfolio
- Credit risk, including credit events and rating events
- Changes in interest and exchange rates
- Redemptions
- Spread changes of indexes to which interest rates of securities are tied
- Macro-economic shocks

The reform of the EU's EUR 1.3 trillion MMF industry was due to be implemented by January 2019, but in 2018 a debate arose about whether the new regulation permits the continued use of “share cancellation”, used by certain types of MMFs to deal with negative interest rates. The interpretation of the Commission's Legal Services prevailed and share cancellation is now not permitted. The regulators in **Luxembourg** and **Ireland** – the EU's two largest MMF

<sup>53</sup> Comisión Nacional del Mercado de Valores

<sup>54</sup> [https://www.cnmv.es/DocPortal/Publicaciones/Informes/Informe\\_Anuar\\_2017\\_en.PDF](https://www.cnmv.es/DocPortal/Publicaciones/Informes/Informe_Anuar_2017_en.PDF)

<sup>55</sup> Dubai Financial Services Authority

<sup>56</sup> [http://dfsa.complinet.com/en/display/display\\_main.html?rbid=1547&element\\_id=23663](http://dfsa.complinet.com/en/display/display_main.html?rbid=1547&element_id=23663)

<sup>57</sup> <https://www.fca.org.uk/publication/corporate/sector-views-january-2019.pdf#investment-management>

<sup>58</sup> <http://ami-france.org/Reglementation/Dossiers-thematiques/Epargne-et-prestataires/Divers-gestion-d-actifs/Le-HCSF-publie-une-analyse-des-interconnexions-entre-la-gestion-d-actifs-et-le-reste-du-syst-me-financier-en-France>



Despite major post-crisis reforms to the rules governing MMFs...regulation of this section of the industry continues to develop.



domiciles – moved the deadline back by two months to 21 March 2019 to allow managers to resubmit their applications and implementation plans.

### Exchange-traded funds still on the watch list

Consideration of the growing ETF markets has been a focus of global policy analysis for some time and ETFs remain on the systemic risk watch list. Concerns about potential risks appear, though, in stark contrast to the more positive remarks made by some regulators about the lower costs of passively-managed funds (see Chapter 4).

As part of its 2019 work program, IOSCO says it will examine “whether the growth of passive investment affects the price discovery process” and scrutinize the effect of passive funds on “the allocation of capital and corporate governance.” It will also investigate the role of index providers.

ASIC carried out a review of the **Australian** ETP market – covering ETFs and other types of exchange-traded instruments – and identified a range of risks, including that issuers should:

- Be more proactive in monitoring the performance of ETPs
- Publish the indicative NAV with a frequency that enables investors to make more informed decisions
- Be aware of market maker concentration risk and manage it
- Review and, if necessary, wind down ETPs that do not meet ongoing suitability

The SEC, on the other hand, is proposing to simplify and modernize the **US** regulatory framework governing ETFs, and to enhance information to investors about the costs of purchasing ETF shares. The proposed changes would allow most ETFs to operate without first obtaining exemptive relief, provide greater flexibility with respect to aspects of ETF operations and require additional disclosures regarding ETFs’ trading costs, including certain bid-ask spread information.

<sup>59</sup> [http://www.amf-france.org/en\\_US/Publications/Lettres-et-cahiers/Risques-et-tendances/Archives?docId=workspace%3A%2F%2FSpacesStore%2F28bd5080-6c2d-4154-a015-1b7678210b64&langSwitch=true](http://www.amf-france.org/en_US/Publications/Lettres-et-cahiers/Risques-et-tendances/Archives?docId=workspace%3A%2F%2FSpacesStore%2F28bd5080-6c2d-4154-a015-1b7678210b64&langSwitch=true)

<sup>60</sup> Circular Nr. 05/2018 of 26 September 2018

<sup>61</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-consults-stress-testing-rules-money-market-funds>

## Other fund regulation

More generally, regulators are liberating fund rules in some areas, while still having a keen eye to their systemic risk remits.

The **Canadian** Securities Administrators (CSA), the umbrella group of provincial and territorial regulators, published amendments to the Alternative Mutual Funds Framework.<sup>62</sup> The CSA introduced a comprehensive framework for alternative mutual funds (previously called commodity pools) in January 2019 and streamlined the regulation of non-redeemable investment funds.

“These amendments mark a new phase in the CSA’s efforts to modernize the regulation of publicly offered investment funds, while maintaining appropriate investor protection measures”, said Louis Morisset, CSA Chair.

The amendments update the investment restrictions for alternative mutual funds to allow greater flexibility within investing strategies, with a focus on strategies typically associated with “liquid alternatives”. These include increased concentration limits, more flexibility for fund-of-fund investing, an increased ability to borrow cash for investing purposes, and increased flexibility to short-sell and use derivatives. The changes bring alternative mutual funds fully into the prospectus disclosure regime.

With the legalization of cannabis, Canada has seen a number of funds investing in production companies. The market cap of such companies is growing fast, but it is challenging to market the funds to foreign investors.

Meanwhile, the **Spanish** fund association, Inverco<sup>63</sup> wants fund managers to be able to close funds to new money when they believe achievement of the investment strategy is being impacted by the large size of the fund. If adopted by the regulator, the proposals would bring Spanish rules for temporary fund closures into line with the rest of Europe.

In **Hong Kong**, the SFC<sup>64</sup> launched a consultation on Proposed Amendments to the Unit Trusts Code<sup>65</sup> to identify when the use of derivatives could reasonably be considered as risk mitigation, including hedging and netting, or gaining efficient market access, rather than only to create leverage in funds. The SFC is working on final refinements to identify derivatives that are not used for leverage in order to amplify returns. It also published a list of SFC-authorized derivative funds so that distributors can clearly identify which ones are subject to additional suitability assessments.

In **Poland**, bond funds must value all financial instruments at fair value. From January 2020, the valuation method applied to unquoted corporate bonds will change.

Investment fund companies will need to develop appropriate valuation models and disclosures.

In **China**, a raft of new asset management rules is a sign that its asset management sector is entering a new era, which is expected to lead to healthier development of the securities markets, fostering of financial stability and prevention of market risk. The new rules are designed to unify a range of rules covering asset management products and are issued by various financial regulators. The aim is to minimize regulatory arbitrage, to reduce financial leverage ratios in the asset management sector, to rein in the rapid growth of the “shadow banking” sector, and to halt the issuance of high-leverage and risky investment products with guaranteed principal and fixed-yield returns.

## Risk-free rates and benchmarks: all change

An important structural shift for the industry is the phasing out of the interbank offered rates (IBORs), which underpin the trading of a wide range of wholesale and retail products. When moving to the new risk-free rates (RFRs), asset and fund managers need to consider instrument valuations, hedging and basis risks, liability-driven investment, cross-currency trades, ETFs, contracts and fund documentation.

Regulators are focused on the implications of the transition to the new RFRs. For instance, an ECB paper in February 2019 highlighted the factors impacting the industry, what buy-side firms should consider and where they should start.<sup>66</sup>

In its 2018 Markets and Risk Outlook,<sup>67</sup> the **French** regulator noted that the legal validity of existing financial instruments and contracts could be called into question, and that changes in reference rates could lead to

**“The reforms to interest rate benchmarks will have a big impact across financial markets, from Wall Street to Main Street. Making sure the entire market appreciates the scale of the issue and takes early action is therefore a priority.**

**Given the scale of the task, this is not something that can be resolved in the months before end-2021. To ensure a successful and orderly transition, institutions need to be taking action – and starting now.”**

Scott O’Malia, Chief Executive Officer,  
International Swaps and Derivatives Association,  
4 July 2018

<sup>62</sup> [https://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20181004\\_amendments-finalize-alternative-mutual-funds-framework.htm](https://www.osc.gov.on.ca/en/NewsEvents_nr_20181004_amendments-finalize-alternative-mutual-funds-framework.htm)

<sup>63</sup> Asociación de Instituciones de Inversión Colectiva y Fondos de Pensiones

<sup>64</sup> Securities and Futures Commission

<sup>65</sup> [https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Ashley\\_20180919.pdf](https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Ashley_20180919.pdf)

<sup>66</sup> [https://www.ecb.europa.eu/paym/initiatives/interest\\_rate\\_benchmarks/WG\\_euro\\_risk-free\\_rates/html/index.en.html](https://www.ecb.europa.eu/paym/initiatives/interest_rate_benchmarks/WG_euro_risk-free_rates/html/index.en.html)

<sup>67</sup> [https://www.amf-france.org/en\\_US/Publications/Lettres-et-cahiers/Risques-et-tendances/Archives?docId=workspace%3A%2F%2FspacesStore%2F543a184a-4e98-466d-84eb-27e97e120ce5](https://www.amf-france.org/en_US/Publications/Lettres-et-cahiers/Risques-et-tendances/Archives?docId=workspace%3A%2F%2FspacesStore%2F543a184a-4e98-466d-84eb-27e97e120ce5)

significant portfolio reallocations. And in the **Netherlands**, one of the AFM's 2019 priorities is to investigate the transition risks to new interest rate benchmarks.

Meanwhile, certain provisions in the new **EU** Benchmark Regulation are causing concern. None of the three ways of authorizing third-country benchmark interest rates are proving workable. As a result, important benchmarks — especially those in Asia — may not be authorized for use by the January 2020 deadline.

## Industry growth prompts new policy debates

Back in November 2017, the OECD<sup>68</sup> issued a report on “common ownership” by institutional investors and its impact on competition.<sup>69</sup> Common ownership – or “horizontal shareholding” – is the practice of investing in various companies in the same sector that are competing. The report noted the relevance of competition laws, but that empirical results can be hard to interpret for antitrust agencies. It also recognized that any policy proposals to counter the impact of common ownership could have unintended and detrimental consequences.

Recently, the debate has been given another push in both the **EU** and the **US**, prompted by observations about the increasing amount of assets under management. Large passive funds have attracted particular attention. In December 2018, the US Federal Trade Commission conducted a hearing on the topic. The US SEC is also concerned about size, but from the perspective of mergers of asset management companies, as fees are driven down and the bargaining power of large firms increases.

When speaking at an Investment Company Institute conference in March 2019, Dalia Blass, SEC Director of Investment Management said she was concerned about what it will mean for main street investors if the variety and choice of small and mid-sized asset managers becomes lost in a wave of consolidation and fee compression.

Such concerns are in contrast to the regulatory pressure elsewhere – as described in Chapter 4 – for asset and fund managers to lower fees and charges.

## Moving to risk-free rates



**RFR program set-up:** develop and manage a cross-functional RFR program that handles all business lines and jurisdictional differences.



**Initial impact assessment:** undertake modelling and systems analysis in all business units, considering operational, legal and conduct risk, functional impacts, economic implications, regional transitions and timings.



**Strategic planning:** establish client communication and negotiation workflows, review contract structures and evaluate profitability, cash-flows and hedging risk.



**Governance and client outreach:** develop internal governance processes to approve changes to policies, systems, processes and controls; ensure that clients are treated fairly through the transition; and educate client-facing staff to help guide clients through the process.



**Contract identification:** identify all products and business lines, including expected fall-backs, and the bilateral negotiations likely to be in scope.



**IBOR exposures and risk management:** have a clear measure of IBOR exposure broken down by maturity beyond 2021, and grouped by fund, portfolio and counterparty.

For more information on what asset managers need to do and how they might do it, see “Moving to risk-free rates.”<sup>70</sup>



### Moving to risk-free rates

<sup>68</sup> Organisation for Economic Co-operation and Development

<sup>69</sup> [https://one.oecd.org/document/DAF/COMP\(2017\)10/en/pdf](https://one.oecd.org/document/DAF/COMP(2017)10/en/pdf)

<sup>70</sup> <https://assets.kpmg/content/dam/kpmg/xx/pdf/2019/01/evolving-libor-risk-free-rates.pdf>



## Chapter 3

# Governance and conduct ethos spread

As we emphasized in last year's report, governance and conduct are now global regulatory preoccupations. It is no longer enough for firms simply to adhere to rules and regulations. External voices require them to think more broadly about the impact of their culture and conduct.

Regulators have made it clear that there has to be accountability for the implementation of such rules. There are increasing demands – by external voices – worldwide for individuals within the financial services industry to be held personally to account for their actions.

Diversity, remuneration and stewardship are all on the agenda, as are delegation practices, the prevention of money laundering and market abuse, and distribution requirements.

## Upheaval led by Australia's Royal Commission

The Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry published its final report in February 2019.<sup>71</sup> The aim of the Commission was to consider whether actions by financial services firms amounted to misconduct. It concluded that supervision must be extended to non-financial risks, in particular culture, governance and remuneration. These risks, the report said, begin and end with leadership.

Changing culture and governance is the centerpiece of the report. Financial services firms operating in **Australia** must thoroughly assess their culture and governance, identify and deal with problems, and measure whether the changes are effective. This recommendation seems little different from the existing Prudential Standard CPS220. However, the requirement to assess whether changes are effective is a game changer and a real challenge to the industry.

APRA will supervise culture and take a more active role, including "assessing the cultural drivers of misconduct in entities". The recommendation suggests a "risk based approach," given that cultural assessments can be resource-intensive.



Firms must balance the interests of shareholders, employees and customers. Culture plays a critical role in this.



APRA has signaled it expects firms to demonstrate they have considered how the issues raised in the report might apply to them. In order to do this, firms need to analyze:

- Current systems of governance
- Systems of risk and compliance
- Allocation of accountabilities
- Remuneration governance, policies and practices
- Culture and its impact on risk management

The report recommends the removal of conflicts of interest where possible. This is unlikely to be feasible in all cases, so the key question is – when conflicts of interest remain, are frameworks operating effectively to manage them? Firms must balance the interests of shareholders, employees and customers. Culture plays a critical role in this.

## Other countries follow the same path

**South Africa** has also instituted considerable change on conduct matters, following its adoption of the "Twin Peaks" regulatory model (see Chapter 1). National Treasury is proposing an all-encompassing framework of principles and objectives in the Conduct of Financial Institutions (CoFI) Bill. A long consultation period – until 1 July 2019 – underlines the importance and far-reaching nature of these reforms.

The CoFI Bill aims to strengthen the regulation of how the financial services industry treats its customers. It will streamline the framework for the regulation of the conduct of financial institutions and give legislative effect to the market conduct policy approach, including implementation of the "treating customers fairly" principles. These principles currently have little legal backing in South Africa.

The direction of regulatory travel is from institutional supervision to activity monitoring and from box-ticking of rules to principles-based requirements. The regulators will adopt a risk-based and proportionate approach to their monitoring activities, relative to the nature, size and complexity of the risk and the firm concerned. Firms will need to manage the sheer volume of regulatory change and to upskill.

In **Switzerland**, FinSA introduced conduct rules for providers of financial services that are largely based on MiFID II and the PRIIPs Regulation, but contain a Swiss finish. Previously, such conduct rules had their legal basis only in civil law. FinSA will introduce them into supervisory law, which will allow FINMA to enforce compliance.

In **Qatar**, a new code for listed entities is applicable from 2019 and there is a consultation on extending the code to unlisted entities, including asset managers and funds. Qatar Financial Markets Authority (QFMA) based its principles on international and regional codes of governance, including those of the G20, the OECD, IOSCO and the International Corporate Governance Network.

The code determines the principles for the allocation of rights and duties among different stakeholders of a fund, such as board members, managers and investors, and outlines the rules and procedures for decision-taking. Funds must have an independent board of directors.

The **UK** FCA consulted in 2018 on a potential duty of care rule. Firms are already subject to a fiduciary rule that requires them at all times to act in the best interests of their clients. A duty of care is an obligation to exercise reasonable care and skill when providing a product or service. It can be described as a positive obligation, whereas a fiduciary duty is largely a prohibition.

<sup>71</sup> <https://financialservices.royalcommission.gov.au/Pages/reports.aspx>

The majority of respondents thought that levels of potential harm to consumers are high and that change is needed. The FCA is now reviewing how it applies the current regulatory regime and is considering new or revised Principles to strengthen and clarify firms' duties to consumers. It is also considering a potential private right of action for Principles breaches.<sup>72</sup>



A duty of care is an obligation to exercise reasonable care and skill when providing a product or service.



In **India**, SEBI<sup>73</sup> is increasing its focus on governance and operational discipline in asset managers and is requiring fund trustees to make additional checks. Inspections are reported to be more vigorous and regulatory tolerance lower, with increased enforcement of non-compliance. New rules prohibit fund expenses to be borne by the manager, to ensure a level playing field. Individual fund trustees and the auditors of funds must rotate at least every 10 years, as already required for fund management companies.

A draft law is being finalized that will authorize and regulate fund administrators in **Cyprus**. The new law is expected to:

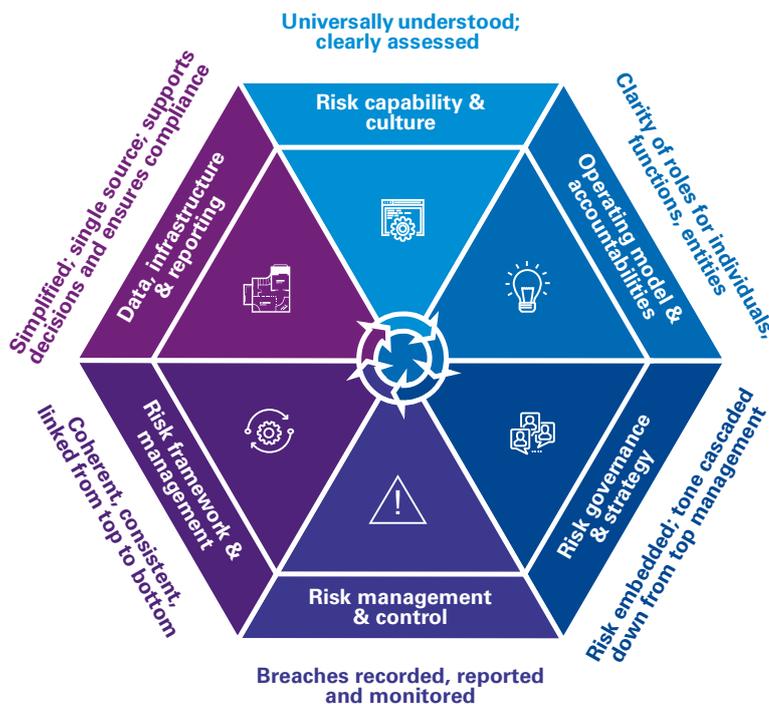
- Enhance the confidence of AIFMs and investors in the jurisdiction
- Drive higher levels of transparency, integrity and quality
- Assist fund administrators in meeting minimum standards
- Bring the industry and jurisdiction on a par with competing European fund domiciles

### Rise of individual accountability

There are increasing demands worldwide for individuals within the financial services industry to be held personally to account for their actions. These demands are being met by regulators.

In **Singapore**, MAS guidelines on individual accountability and conduct (proposed in April 2018) are expected to be finalized before end-2019. The guidelines set out five outcomes that firms are expected to work towards by implementing appropriate policies and processes to address MAS's expectations. They reinforce firms' responsibilities by:

## Governance, risk and controls



<sup>72</sup> <https://www.fca.org.uk/news/press-releases/financial-conduct-authority-publishes-feedback-statement-duty-of-care>

<sup>73</sup> Securities and Exchange Board of India

- Promoting the individual accountability of senior managers
- Strengthening the oversight of employees in material risk functions
- Embedding standards of proper conduct among all employees

In the **UK**, the Senior Managers and Certification Regime (SMCR) will be extended from banks to asset managers in December 2019. “Firms’ culture and governance is pivotal to building public trust and confidence in the UK’s financial services industry,” said Andrew Bailey, CEO of the FCA.<sup>74</sup>

The SMCR is a key tenet of the FCA’s drive to cultivate appropriate behaviors, aiming to reduce harm to consumers and strengthen market integrity. SMCR

“ There are increasing demands worldwide for individuals within the financial services industry to be held personally to account for their actions. ”

requires firms to set the tone from the top. Asset managers will have to list risk-takers in a publicly-available FCA directory. The directory will provide a record of job histories of all “material risk takers”.

Under the extended regime, firms will be classified, depending on their complexity and risk, into three categories:

- Enhanced, which will apply to the most significant firms and applies extra rules to a small number of solo-regulated firms.
- Core, where most asset and wealth management firms will find themselves.
- Limited regime, which will be applied to others, including “internally-managed” AIFs, and which will impose fewer requirements on firms subject to the existing approved persons regime.

“Senior manager functions” will replace the current regime and “prescribed responsibilities” must be allocated to the most senior person responsible for a particular activity. The conduct rules set the basic standards of good personal conduct, against which people can be held to account, and are applicable to all firms, including their branches.

<sup>74</sup> FCA Business Plan, 2018/19



In December 2018, Andrew Hauser, Executive Director of Markets at the Bank of England said the bank wants asset managers operating in the UK to sign up to the voluntary FX Global Code of Conduct, established by 16 central banks after the 2013 foreign exchange benchmark scandal. “You are a vital part of the market, and play a crucial role in maintaining market discipline,” he said. He also noted that signing up to this recognized market code would demonstrate that a firm is observing proper standards of market conduct – a key requirement of SMCR.



We would prefer to see the firms we supervise taking steps to increase diversity levels on a voluntary basis.



Back to **Australia**, where the Royal Commission has recommended extending the Banking Executive Accountability Regime (BEAR) to insurers and superannuation funds, which will require firms to name an accountable person for products. BEAR considers an accountable person as a director, executive or other person with significant influence over conduct and behavior. Requirements include the development of an accountability statement, an accountability map for the organization and remuneration requirements. Senior management must take “reasonable steps” to comply with all legal and regulatory obligations – but BEAR does not define these steps.

In April 2019, the CBI issued a “Dear CEO” letter<sup>75</sup> to all **Irish** regulated firms, reminding them of their obligations under the fitness and probity regime. It said there was “a lack of general awareness” of the rules, which impose significant obligations on firms to ensure that senior and other key personnel comply with the regime’s requirements.

In **Luxembourg**, the CSSF issued a circular for AIF depositaries,<sup>76</sup> introducing a requirement to appoint a person responsible for the depositary business line, who should either have adequate professional experience or be in charge of a team that collectively has such experience.

## Diversity: social objective becomes regulatory imperative

A year ago, the CBI warned Irish firms it would impose gender diversity requirements if improvements are not made.<sup>77</sup> 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 says, contributed to the financial crisis.

Donnery said progress by supervised firms was “slow.” She added, “We would prefer to see the firms we supervise taking steps to increase diversity levels on a voluntary basis. But in the absence of improvements [we] will have to consider whether it is necessary to put specific requirements in place.” The CBI is actively monitoring developments.

Meanwhile, diversity has also become an important supervisory issue in the **UK**. Christopher Woolard, Executive Director of Strategy and Competition at the FCA, said in a speech<sup>78</sup> in December 2019 that diversity has moved from “nice to have” to a commercial imperative. How a firm approaches diversity and inclusion tells the FCA a lot about its culture, he said. While progress has been made, more needs to be done. The percentage of women at senior management level has only increased by 1.5 percent in the UK over the last 10 years, to 15.5 percent.

The industry is already responding. The UK Investment Association’s annual stewardship survey 2018<sup>79</sup> found that over half (56 percent) of asset managers had engaged with UK companies on gender diversity and 42 percent had made a voting decision based on this.

In June 2018, the **Italian** asset management association, Assogestioni established a Diversity Committee. Its remit is:

- To analyze the adoption of diversity criteria (age, gender, educational and professional background) in the composition of management bodies and (in terms of age and gender) among top executives of asset management companies;
- To identify initiatives aimed at raising awareness of the adoption of diversity policies and measures that ensure equal treatment and equal opportunities for personnel of both genders; and
- To define best practice.

In August 2018, the Bank of Italy, as part of a consultation document on the governance, extended to fund managers the principles regarding diversity envisaged by MiFID II.

## Compensation a key EU governance issue

During **EU** discussions on new capital requirements rules for non-banks – the Investment Firm Directive (IFD) and Investment Firm Regulation (IFR) – a proposal to cap bonuses for bank-owned asset managers was rejected. Instead, the new rules, which will take effect during 2021, explicitly permit NCAs to impose a cap on individual firms if they are not happy with the firms’ remuneration policies.

<sup>75</sup> <https://www.centralbank.ie/docs/default-source/news-and-media/press-releases/190408-dear-ceo-letter-fandp.pdf>

<sup>76</sup> [http://www.cssf.lu/fileadmin/files/Lois\\_reglements/Circulaires/Hors\\_blanchiment\\_terrorisme/cssf18\\_697.pdf](http://www.cssf.lu/fileadmin/files/Lois_reglements/Circulaires/Hors_blanchiment_terrorisme/cssf18_697.pdf)

<sup>77</sup> <https://www.bis.org/review/r180511f.htm>

<sup>78</sup> <https://www.fca.org.uk/news/speeches/opening-and-speaking-out-diversity-financial-services-and-challenge-to-be-met>

<sup>79</sup> <https://www.theinvestmentassociation.org/investment-industry-information/research-and-publications/stewardship-survey.html>

The rules also require shares and derivative options to represent at least 40 percent of variable bonuses, and that at least half of bonuses should be deferred over a five-year period.

Separately, ESMA extended its position on UCITS pay disclosure to encompass non-EU firms.<sup>80</sup> Since 2016, UCITS fund managers have had to disclose the aggregate remuneration of key staff in their annual reports. In June 2018, ESMA said the disclosures should include the remuneration of staff in firms to which the manager has delegated investment management, wherever those firms are based. The industry expressed concerns about the extra-territorial impact of this approach.

“

... disclosures should include the remuneration of staff in firms to which the manager has delegated investment management, wherever those firms are based.

”

In the **Netherlands**, an AFM 2019 priority is to investigate the impact of remuneration and valuation on the culture of the organization and the behavior of staff at large financial organizations. This follows government plans, unveiled in December 2018, to compel Dutch asset management employees to hold on to company shares they receive as part of their fixed remuneration for at least five years. The proposals follow the introduction of a bonus cap in 2015, limiting variable bonuses to 20 percent of pay. In other EU member states, asset managers can pay bonuses of up to 100 percent of salary.

### Stewardship: a perennial regulatory focus

Large **EU** asset managers will have to disclose their corporate investment policies under the IFD/IFR. Firms will have to disclose the companies in which they hold more than 5 percent of shares and how they vote at general meetings. The European Commission has been asked to assess whether the new rules should also apply to UCITS and AIFs.

Meanwhile, the revised Shareholder Rights Directive (SRD II), which applies from June 2019, aims to promote effective stewardship and long-term decision-making among asset managers by increasing the transparency of engagement policies. Reports must include significant shareholder votes and the use of proxy advisers, and must be displayed for free on firms' websites.

### SRD II requirements include:



**Shareholder identification:** issuers have the right to obtain shareholder identification with the objective of engaging directly with the investor



**Information sharing and improved data management processes:** enhancing transparency levels between firms and investors



**Facilitation of the exercise of stakeholders' rights:** fair access to voting and information for all shareholders by improving information transmission along the chain of intermediaries



**Transparency of transactions:** some transactions, including intragroup transactions must be approved at a firm's general meeting



**Investment strategy transparency:** institutional investors, such as asset managers, pension funds or insurers, must establish an investment strategy and publish associated reports on a timely basis



**Proxy adviser transparency:** proxy advisors must establish accurate and reliable voting recommendations and will have to publish a report on their compliance with the code of conduct of proxy advisors



**Remuneration of management:** greater oversight by shareholders over remuneration policy and the evaluation of conflicts of interest; voting on remuneration must take place during the general meeting ("say on pay")

<sup>80</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-updates-ucits-qa>

<sup>81</sup> Association Française de la Gestion Financière

<sup>82</sup> <https://www.fca.org.uk/publications/discussion-papers/dp19-1-building-a-regulatory-framework-effective-stewardship>



In January 2019 the **French** asset management association, AFG<sup>81</sup> released an updated version of its Recommendations on Corporate Governance in line with its motto “Managing well also means voting well”, which promotes pro-active engagement with listed companies.

The **UK** Financial Reporting Council (FRC) and the FCA published papers at the beginning of 2019 on the role played by asset managers in policing governance at companies. The regulators said asset managers should disclose how they hold companies to account.<sup>82</sup> Under the FRC’s proposed revisions to its stewardship code, asset managers must publish how their stewardship activities are implemented within their funds. This is likely to require greater resourcing. In the 2018 annual stewardship report by the UK’s Investment Association, the number of people that carry out stewardship engagements in each firm averaged 33 in 2018, up from 20 in 2017.

### Outsourcing, delegation and substance

Rules governing the outsourcing of key activities by asset managers have been part of the regulatory framework in a number of jurisdictions for some time. Fintech developments such as outsourcing to the cloud have caused regulators to review their requirements across the financial services sector (see Chapter 6).

For **EU** asset and fund managers, in part because of concerns about the impact of “Brexit”, there have been some specific developments in the regulatory approach to outsourcing and delegation, especially to firms outside the bloc.

The CBI released a discussion paper on outsourcing in November 2018 setting out its latest findings.<sup>83</sup> It said the large number of risk mitigation plans issued to **Irish** regulated firms reflects the “significant remediation required to address control and resilience weaknesses” in outsourcing. The CBI said it would continue to engage with firms as it is clear more work is required. It is expected to launch a thematic review in the second half of 2019.

In **Luxembourg** the new delegation and outsourcing contract,<sup>84</sup> by which a depositary delegates its functions or outsources material activities, will grant depositaries the right to access all data in relation to an AIF. However, the circular specifies that where the depositary’s request may lead the delegate or the service provider to be in breach of the law, it is entitled to refuse to provide the information. The contract will also grant the CSSF the right to direct access to the outsourcing company’s office.

<sup>83</sup> <https://www.centralbank.ie/docs/default-source/publications/discussion-papers/discussion-paper-8/discussion-paper-8---outsourcing-findings-and-issues-for-discussion.pdf?sfvrsn=4>

<sup>84</sup> <http://www.kpmgfundnews.eu/lu/2018/08/cssf-issues-circular-18-697-on-organisational-arrangements-applicable-to-depositaries-of-non-ucits-funds/>

The revised **EU** regulations clarifying depositaries' safe-keeping obligations under both AIFMD<sup>85</sup> and UCITS<sup>86</sup> apply from April 2020. The regulations:

- Specify depositaries' duties with regard to the safe-keeping of UCITS and AIF assets
- Require that where a depositary delegates safe-keeping functions to sub-custodians, the assets also need to be segregated by the delegate
- Outline how the obligations are to be fulfilled

As reported in EAMR 2018, Brexit re-opened a long-standing debate about how much "substance" should be retained by a firm that outsources or delegates key functions. In August 2018, the CSSF aligned its residency requirements<sup>87</sup> on **Luxembourg** fund managers with ESMA guidance, clarifying a minimum floor of three full-time equivalent employees in the country. The CSSF demands that senior officers should be based in the country or in a place that allows them to commute to Luxembourg.

National regulators also set limits on directors' workloads. For example, the CSSF said that no single director should have more than 20 directorships and that their professional hours should not exceed 1,920 hours a year.<sup>88</sup> The move came in response to pressure from the International Monetary Fund (IMF)<sup>89</sup> to clamp down on "over-boarding," whereby individuals with a number of directorships lack sufficient time to carry out their duties effectively. However, the CSSF will not publish data on the number of directorships held by individuals.

It is possible that this move is already having an impact, with remuneration of individual directorships already rising. In February 2019, a report<sup>90</sup> found that median pay for independent non-executive fund directors increased to EUR 30,000 per year, compared to EUR 20,000 six years ago. According to the survey, the proportion of Luxembourg UCITS with at least one independent director has increased significantly, from 50 percent six years ago to 89 percent now.

The CBI published a notice of intention<sup>91</sup> in relation to the location requirement for directors and designated persons of **Irish** funds in the event of a "no-deal" Brexit. In such a scenario, the CBI will consider the UK as meeting the effective supervision requirement in its UCITS regulations. Therefore, directors and designated persons located in the UK will be able to continue to service Irish UCITS management companies and Irish AIFMs. (See also Chapter 5.)

## Prevention of money laundering and market abuse

**Swiss** AML legislation is undergoing significant revision. The main driver is the Financial Action Task Force country report of December 2016, which highlighted issues in the Swiss AML regime. The changes also relate to recent developments in the fintech industry.

The amendments are expected to enter into force in 2020 and include:

- People incorporating, managing or administrating companies or trusts will have to adhere to AML due diligence requirements
- Financial intermediaries will be explicitly obliged to verify information on the beneficial owner
- A duty to review periodically whether client data are up-to-date
- Resolution of the ambiguities in the current system for suspicious activity reports

A new code that enters into force in January 2020 will explicitly refer to the FINMA circular on video and online client identification.<sup>92</sup> This circular sets the standard for client identification and establishment of the beneficial owner in a virtual face-to-face situation or via the use of an online channel. It also contains a regulatory requirement for the use of certified electronic signatures in client onboarding.



The protection of whistle blowers is a key regulatory tool in the fight against financial crime and market abuse



Other national regulators around the globe are also focused on AML. In **Japan**, a report was published by the JFSA,<sup>93</sup> which noted there are problems with the methods and depth of AML risk analysis and the depth of AML analysis. The JFSA said it would collaborate to deepen the understanding on the risks on AML and combating the financing of terrorism.

In order to maintain standards, **Jersey** and **Guernsey** have reviewed their AML/CFT<sup>94</sup> legal framework. The **Irish** regulator has consulted on updated AML/CTF guidelines.<sup>95</sup>

<sup>85</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1618&from=EN>

<sup>86</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R1619&from=EN>

<sup>87</sup> <http://www.cssf.lu/en/documentation/regulations/circulars/news-cat/179/>

<sup>88</sup> [http://www.cssf.lu/fileadmin/files/Lois\\_reglements/Circulaires/Hors\\_blanchiment\\_terrorisme/cssf18\\_698.pdf](http://www.cssf.lu/fileadmin/files/Lois_reglements/Circulaires/Hors_blanchiment_terrorisme/cssf18_698.pdf)

<sup>89</sup> <https://www.imf.org/en/Publications/CR/Issues/2017/08/28/Luxembourg-Financial-Sector-Assessment-Program-Technical-Note-Fund-Management-Regulation-45205>

<sup>90</sup> <https://luxtimes.lu/economics/36405-independent-fund-directors-fees-on-the-up-in-luxembourg>

<sup>91</sup> <https://www.centralbank.ie/regulation/markets-update>

<sup>92</sup> <https://www.finma.ch/en/news/2018/02/20180213-mm-rs-video-und-online-identifizierung/>

<sup>93</sup> <https://www.fsa.go.jp/news/30/20180817amlcft/20180817amlcft.html>

<sup>94</sup> counter-terrorist financing

<sup>95</sup> <https://www.centralbank.ie/docs/default-source/publications/consultation-papers/cp128/cp128-anti-money-laundering-and-counteracting-the-financing-of-terrorism-guidelines-for-the-financial-sector.pdf?sfvrsn=2>

In **Luxembourg**, a law entered into force in March 2019 that created a register of beneficial owners in line with the requirements of the 4th and the 5th EU AML Directives. The CSSF is issuing questionnaires to firms about their AML processes. Similarly, in the **Netherlands**, AML compliance is a priority for the AFM. And **Kuwaiti** AML due diligence requirements have been tightened.

A regulatory investigation in the **UK** examined investment firms' controls over potential market abuse. In August 2018, the FCA<sup>96</sup> sent a questionnaire to around 400 fund managers to see how they monitor trading activities. The FCA asked firms whether they undertake automated or manual surveillance and whether they have surveillance to check the use of email, phones and trading tools.

The protection of whistle blowers is a key regulatory tool in the fight against financial crime and market abuse. The **European** Parliament approved new legislative measures in April 2019, which now await agreement in the Council.

In November 2018, the FCA published a review of **UK** whistleblowing rules, setting out good practice.<sup>97</sup> Firms should review the findings and consider reforms to strengthen whistleblowing arrangements, it said. Similarly, in **France**, the AMF published guidelines under the EU whistle-blower regime, outlining the communication channels available to whistle-blowers as well as the terms of declaration, registration and confidentiality rules.

## Distribution and financial advice rules strengthened

Around the globe, there is a focus on sales and distribution practices, including of investment funds. The disclosure of costs and charges is a key component of new and enhanced rules – see Chapter 4 on charges within funds. Also under the regulatory microscope are the description of services offered and the provision of financial advice.

For example, the **Swiss** FinSA includes key requirements related to suitability and appropriateness of advice, general information duties, and the duty to provide key information documents and prospectuses. It introduces the “basic information sheet” (BIB)<sup>98</sup> for all financial instruments offered to retail clients. The BIB must contain the necessary information for investors to be able to make well-founded investment decisions and to compare various financial instruments with each other.

The CNMV has issued a draft technical guide on **Spanish** fund managers' procedures for selecting intermediaries, with an emphasis on conflicts of interest. It also sets out “inappropriate practices”, such as *a priori* trading volumes and certain fee arrangements.

## Three levers to improve the delivery of financial advice:



Efficient provision of advice services – delivery of customer advice through efficient, transparent and simple advice platforms, including the adoption of improved technology



Sustainable financial planning practices, with sufficiently robust revenue streams to support the investment in tools and services that attract and retain financial planners and customers



Ensuring the advice is right-sized for the client's needs and profile, and includes lower-cost options

In the **US**, the SEC has adopted “best interest” regulation for broker-dealers and a rule<sup>99</sup> that will require registered investment advisers to deliver to retail investors a relationship summary. The summary will provide information about the relationships and services the firm offers, the standard of conduct and the fees and costs associated with those services, as well as specified conflicts of interest.

SEC chair, Jay Clayton said in a testimony at a Senate Financial Services and General Governance Committee that the regulation is about preserving choice and protecting investors' interests. The Department of Labor, having been thwarted by a federal appeals court ruling in March 2018 (see EAMR 2018), is working with the SEC on a revised fiduciary rule.

Some states are moving ahead. New Jersey, for instance, is introducing a fiduciary standard for broker-dealers. Also, in a report that describes the EU as leapfrogging the US on investor protection, the Institute for the Fiduciary Standard is calling for broker-dealers to be required to make disclosures to clients on actual fees incurred, in line with MiFID II.<sup>100</sup>

In the **UK**, the FCA said it will evaluate the suitability of financial advice for retail investors over the course of 2019, comparing its results with those published in May 2018. In that document, the FCA found that advice was suitable 93.1 percent of the time but unsuitable or unclear in 4.3 percent and 2.5 percent of cases, respectively. In particular, the FCA criticized automated service providers over suitability failings, and “unclear” service and fee disclosures.<sup>101</sup>

<sup>96</sup> <https://www.fca.org.uk/publication/newsletters/market-watch-56.pdf>

<sup>97</sup> <https://www.fca.org.uk/publications/multi-firm-reviews/retail-and-wholesale-banking-review-firms-whistleblowing-arrangements>

<sup>98</sup> [basicinformationsblatt](https://www.fca.org.uk/publications/multi-firm-reviews/retail-and-wholesale-banking-review-firms-whistleblowing-arrangements)

<sup>99</sup> <https://www.sec.gov/rules/proposed/2018/ia-4889.pdf>

<sup>100</sup> <https://thefiduciaryinstitute.org/2019/04/22/the-eu-leapfrogs-the-us-on-investor-protection/>

<sup>101</sup> <https://www.fca.org.uk/publications/multi-firm-reviews/automated-investment-services-our-expectations>

Back again to **Australia**, where financial advisors need to consider how to implement the three Royal Commission recommendations into their models:

1. Customer centricity and the best interest duty
2. Improving professional standards of financial advisers
3. Removing the impact of conflicted remuneration

The **Canadian** regulators are split on whether to require dealers to perform “suitability” determinations for clients. Meanwhile, the rules on fair dealing and conflicts of interest are still in the supervisory spotlight.

SEBI issued an advisory notice on foreign trading portals,<sup>102</sup> noting that many online web portals offer services to **Indian** residents through electronic messages, blogs, advertisements, websites, emails and apps, without complying with basic know-your-customer procedures. The inherent complexity of the products offered by many firms may not suit the risk profile of investors, SEBI said, and their excessive leverage can result in significant losses to investors. It cautioned investors to avoid unregulated web portals.

In the **UK**, the FCA published its final report, following its investment platforms market study. It is consulting on proposals:

- To make transfers simpler and easier, so that consumers can move assets to new platforms without the unnecessary liquidation of investments
- To restrict platform exit fees in order to reduce consumer harm
- To improve competition, increase efficiency and improve the consumer experience

The UK regulator is calling for input on the financial advice market. It is also seeking comments on how retail distribution has been impacted by the ban on commissions, which pre-dated and is stricter than the MiFID II rules on inducements.

<sup>102</sup> [https://www.sebi.gov.in/media/press-releases/oct-2018/advisory-in-respect-of-foreign-trading-portals\\_40848.html](https://www.sebi.gov.in/media/press-releases/oct-2018/advisory-in-respect-of-foreign-trading-portals_40848.html)





## Chapter 4

# Costs and charges: out-of-balance with expectations?

There is a balance between what is reasonable for investors to be charged and the profits made by investment firms. Regulators are aware of this fine balance and are in the midst of a multi-year push to set rules and principles that allow investment firms to prosper and also to engender an industry that is considered equitable by investors large and small.

Society, through politics, the media and the explosion in social media, demands this equilibrium is found. These external voices are loud and persistent.

Regulators are therefore increasingly focused not only on the calculation and format of disclosures, but also on the level of costs disclosed. The use of benchmarks, too, is under the regulatory microscope.

## Fee and cost disclosures on regulatory radar

Regulators are concerned about appropriate cost and fee disclosures along the supply chain. There is a focus on cost disclosures by funds, distributors and asset managers.

Transparency is key to engaging investors. Retail investors may be put off from investing in funds if they cannot easily collect and compare information on investment products, according to a **European** Commission study.<sup>103</sup> This, together with widely divergent fees, was the main finding of the study published in 2018 into the distribution of retail investment products.

“Retail investors may be put off from investing in funds if they cannot easily collect and compare information on investment products”

The research, based on mystery shopper exercises in 15 member states, found that marketing documents are “not systematically transparent [and are] in no way standardized across countries.” This is particularly true of disclosures relating to costs, the Commission said, criticizing in particular cost disclosures of ETFs and real estate funds.

The Commission said it would help develop online fund comparison tools by using an external provider to assess the current offering of commercial financial product comparison services.

The **Swedish** regulator surveyed 25 funds-of-funds managed by 25 UCITS managers and AIFMs, scrutinizing to what extent consumers are informed about fees and how the managers have reported their funds-of-funds’ objectives and performance. The survey<sup>104</sup> indicated that fees charged for Swedish funds-of-funds are generally high, especially when compared with index funds and equity funds. Close to half of the funds-of-funds surveyed do not use a benchmark index, which makes it more difficult for consumers to evaluate return targets.

The **UK** FCA signaled in August 2018 that it would take enforcement action against firms that used shortcuts to comply with MiFID II. Some fund managers have found it difficult to implement the transaction cost methodology in the regulations, due to a lack of available data, and have been using alternative methodologies instead.

As part of its Asset Management Market Study (AMMS) follow-up, the FCA will publish a brief update on its assessment of whether fund disclosures have become

progressively clear, consistent and meaningful, after 12 and 24 months. The Investment Association published its guidance on fund communication in February 2019 as part of its work with the fund objectives working group.

In addition, the FCA said the pricing and quality of bundled custody and investment administration services is a potential concern, particularly for smaller asset managers. Some asset managers (particularly small ones) could be overpaying for bundled custody and investment administration services.

**Canada** is one of a growing number of jurisdictions that is witnessing increased media attention on costs. The Mutual Fund Dealers Association of Canada (MFDA) – which has regulatory powers – is expanding the way investment fees are reported to investors to include ongoing costs, such as management expense ratios. Nearly ten years on from the introduction of the first phase of the “Client Relationship Model” (CRM), and over three years since the introduction of CRM2, such disclosures were not previously required.<sup>105</sup>

In April 2018, the MFDA issued a discussion paper asking for industry feedback on four areas not covered by CRM2: continuing costs of owning investment funds; transactional costs, such as redemption fees and short-term trading fees; third-party custodial and intermediary fees to administer the fund; and the costs of other investment products not currently included in the annual charges and compensation report.

Also in Canada, the CSA proposed rules to prohibit certain embedded commissions.<sup>106</sup> Investment fund managers would be prohibited from paying upfront sales commissions to dealers, and trailer commissions to dealers who do not make a suitability determination, such as execution-only dealers. All forms of the deferred sales charge option would also be eliminated. The regulatory debate now seems to be moving away from an outright ban, but market practice is changing anyway.

The CSA are also proposing to eliminate certain disclosure requirements in the simplified prospectus form, in the Fund Facts document and under dealer disclosure rules, because these would no longer be necessary. The 90-day comment period closed in December 2018.

In the **US**, the SEC issued a request for comment seeking feedback on improving the content, design and delivery of fund disclosure, which ended in October 2018.<sup>107</sup> Dalia Blass, SEC Director of Investment Management said a fund’s prospectus and summary prospectus should tell the story of the fund, providing a reliable roadmap of the fund’s strategies and key risks. “We regularly see disclosure in which length trumps clarity and the story is buried,” said Blass. She said the SEC wanted to work with industry on disclosure in the future.

<sup>103</sup> [https://ec.europa.eu/info/publications/180425-retail-investment-products-distribution-systems\\_en](https://ec.europa.eu/info/publications/180425-retail-investment-products-distribution-systems_en)

<sup>104</sup> <https://www.fi.se/en/published/reports/supervision-reports/2018/fi-supervision-4-survey-of-funds-of-funds/>

<sup>105</sup> <http://mfda.ca/bulletin/bulletin0748/>

<sup>106</sup> [https://www.osc.gov.on.ca/en/NewsEvents\\_nr\\_20180913\\_csa-propose-rules-to-prohibit-certain-embedded-commissions.htm](https://www.osc.gov.on.ca/en/NewsEvents_nr_20180913_csa-propose-rules-to-prohibit-certain-embedded-commissions.htm)

<sup>107</sup> <https://www.sec.gov/news/speech/speech-blass-102518>



We regularly see disclosure in which length trumps clarity and the story is buried.



The Commission also issued a request for comment on the framework for fees that intermediaries charge to deliver disclosure documents and proposed a short-form summary to explain the terms of an investor's relationship with a broker-dealer or investment adviser.

**Japan's** JFSA published key performance indicators to help comparability in the industry:

1. Customer ratio categorized by the investment results of investment trusts and fund wrappers
2. Cost-return of the top 20 securities within an investment trust portfolio
3. Risk-return of the top 20 securities within an investment trust portfolio

The Japanese Investment Trusts Association partially revised the Regulations on Investment Reports etc. for investment trusts and investment corporations, establishing disclosure of the total expense ratio. The revised regulations will be effective from September 2019, although early adoption is permitted. And in **Singapore**, since December 2018 fund managers have been required to disclose the range of trailer fees paid to distributors.<sup>108</sup>

In **Australia**, ASIC set out in January 2019 guidance on disclosing fees and costs for retail and pension fund providers.<sup>109</sup> The disclosures must:

- Describe certain transactions in periodic statements
- Disclose indirect costs and, in the case of a superannuation product, other fees
- Disclose total fees and costs
- Provide certain additional information

The calculation metrics are being specified by the regulator, which is requiring operational change for firms and is leading to shifting fee structures – between base and performance fees, for example.

In **Switzerland**, FinSA introduced rules on how and when properly to disclose costs and charges to clients. The handling of commissions, inducements and the like has already been clarified by the Swiss Federal Court. In a nutshell, asset managers are allowed to keep

inducements if they properly disclose them to their clients in good time and the client waives the inducement. With the introduction of FinSA this ruling will now become supervisory law.

The **UK** FCA said, in February 2019, that it was investigating 48 investment firms for failing to meet cost disclosure requirements under MiFID II.<sup>110</sup> Under MiFID II, investment firms must disclose all fees, including management fees, and those of underlying funds, including transaction costs, in a single disclosure.

Meanwhile, a regulator-backed working group in 2018 finalized cost disclosure templates to be used on a voluntary basis by asset managers and institutional investors. The Institutional Disclosure Working Group, set up by the FCA, is comprised of investors, asset managers and independent experts. It submitted templates for data collection and disclosure to the FCA, and recommended the creation of a new body to curate and update the framework.

Non-compliance could result in deselection from requests for proposal and the non-renewal of contracts. The FCA Chief Executive, Andrew Bailey told the UK parliament's Work and Pensions Committee in February 2019 that it would “step in” and act against asset managers that do not implement the cost transparency templates. The UK regulator expects firms to have implemented the templates within a year. Institutional clients, too, are applying pressure. Large pension schemes have said they will publicly dispense with the services of non-exempt asset managers – an example of the power of the client voice.

## The European KID drama

The key to a fair industry is transparency, and investor documents that disclose key information are critical to this (see also Chapter 3). There is, however, considerable controversy about what these documents should contain and the underlying calculations behind the disclosed figures. The debate is most heated in **Europe**.

All has not gone smoothly in the creation of the PRIIP KID, which came into effect in January 2018. Both the future performance and the transaction cost disclosures have produced some extreme figures. For example, some funds are having to disclose negative transaction costs, while others have to disclose very high costs that seem out-of-line with reality.

Fund managers say the results are down to flawed methodology. There are also issues with the availability and reliability of data for certain assets and markets. However, the **UK** FCA has argued that such results are outliers and are mainly due to errors made by firms in implementing the methodologies.<sup>111</sup>

<sup>108</sup> [http://www.mas.gov.sg/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Funds-Management/Regulations/2018/Securities-and-Futures\\_Offers-of-Investments\\_CIS\\_Amendment-Regulations-2018.aspx](http://www.mas.gov.sg/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/Securities-Futures-and-Funds-Management/Regulations/2018/Securities-and-Futures_Offers-of-Investments_CIS_Amendment-Regulations-2018.aspx)

<sup>109</sup> <https://asic.gov.au/regulatory-resources/superannuation-funds/fees-and-costs-disclosure/rq-97-review/>

<sup>110</sup> <https://www.fca.org.uk/publications/multi-firm-reviews/mifid-ii-costs-and-charges-disclosures-review-findings>

<sup>111</sup> <https://www.fca.org.uk/publication/feedback/fs19-01.pdf>

EFAMA<sup>112</sup> published pan-**European** evidence that the methodology for calculating transaction costs and the disclosure of performance data are “fundamentally flawed.”<sup>113</sup> Likewise, the **UK** Association of Investment Companies (listed, closed-ended AIFs) presented evidence that KIDs “are systematically flawed due to their reliance on past performance as a basis for future projections.”<sup>114</sup> The association suggested that, meanwhile, investors should “burn before reading”.

It is reported that the **German** association even went as far as to warn its members against using the PRIIP methodology to meet their cost disclosure obligations under MiFID II, saying that doing so carries a legal risk. MiFID II cost disclosure rules specifically exclude market risk, whereas the industry argues that the PRIIP KID methodology captures it.

Fund managers and distributors say the current disclosures are potentially misleading to investors. Many voices, including both consumer and industry representatives, have expressed concern and called for a fundamental review of the performance and costs rules.

NCAs increasingly acknowledge there is a serious issue. In November 2018, the ESAs issued proposals to address certain of the concerns, but feedback from respondents was that the changes would not be sufficient. The ESAs’ report in February 2019<sup>115</sup> therefore recommended that a fuller **EU** review should be undertaken, including more consumer testing.

“ ... the current disclosures are potentially misleading to investors. ”

As a temporary fix, the ESAs recommended an additional risk warning for the performance figures: “Market developments in the future cannot be accurately predicted. The scenarios shown are only an indication of some of the possible outcomes based on recent returns. Actual returns could be lower.” It is not known what retail investors will understand from this statement and it is not clear how it can be added to the KID without amendment of the Level 2 rules.

For investment funds, the debate has been further complicated by the fact that the PRIIP KID implementation deadline was extended by a year to January 2018 but the dates in the regulation relating to the review and the UCITS exemption were not similarly extended.

<sup>112</sup> European Fund and Asset Management Association

<sup>113</sup> <https://www.efama.org/Pages/EFAMA-Evidence-Paper-on-PRIIPs-rules-confirms-shortcomings-of-the-regulation-for-investors.aspx>

<sup>114</sup> <https://www.theaic.co.uk/aic/news/press-releases/aic-calls-for-kids-to-be-suspended>

<sup>115</sup> <https://www.esma.europa.eu/press-news/esma-news/esas-publish-recommendations-changes-priips-key-information-document>





The regulation exempts UCITS until the review date, but presumes that the UCITS KIID<sup>116</sup> will then be replaced by the revised PRIIP KID. The consequence of the squeezing of the timelines would have been that UCITS would for a period have had to provide both the KIID and the KID, which disclose different figures. This raised increased concerns about investor confusion.

The European Commission first proposed to remove the UCITS KIID sooner, but the ESAs and others said the original timeline for the UCITS exemption from the PRIIP KID should be reinstated. In November 2018, the Commission agreed to delay the application of the KID to UCITS by two years, to 2022. Meanwhile, PRIIP KID type data continue to be required for UCITS held within wrapper products, such as unit-linked and with-profits insurance contracts.

The PRIIP KID debate is set to continue into 2020 and beyond.

### Scrutiny of high costs

The level of costs and charges can have a material impact on investors' returns, especially when accumulated over several years. The **Polish** Ministry of Finance, for example, has introduced a maximum management fee for open-ended investment funds of all sorts. From January 2020, the maximum management fee will be 2 percent of the fund NAV per year, down from 3.5 percent.

Other regulators are on a mission to establish just how much the level of costs and charges matter. Within **Europe**, ESMA's first annual statistic report covers UCITS,

retail AIFs and structured retail products. It considered each of these products against member state of domicile and underlying assets.<sup>117</sup> The report findings will likely set the context for the Commission's review of the costs and charges section of the PRIIP KID, and for cost disclosures under MiFID II and the UCITS KIID.

The report finds that there is a high degree of heterogeneity between member states, including for UCITS in relation to performance fee disclosure. This makes comparative analysis difficult, but ESMA notes that ongoing costs have the greatest impact on fund performance. Management fees and other ongoing costs constitute over 80 percent of investors' total costs, while purchase and redemption charges are less significant. Other key findings include that actively-managed funds outperform passive funds on gross returns, but underperform net of costs. Fees levied on UCITS, ESMA found, reduce gross returns by an average of 25 percent.

In its response to the ESMA report, AFG said in February 2019 that over the last decade the annual performance net of costs for **French** funds was 4.38 percent, 3.44 percent and 2.82 percent for equity, diversified and bond categories, respectively – higher than inflation.<sup>118</sup> AFG added that in ESMA's report, investment strategies are rolled into one, so compare products that are different in nature and which do not offer the same service to investors. On the other side of the argument sits the Centre for European Policy Studies, which said ESMA should use its powers to "intervene much more" to tackle high charges.

<sup>116</sup> key investor information document

<sup>117</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-report-finds-investment-product-performance-highly-impacted-charges>

<sup>118</sup> <https://www.afg.asso.fr/en/costs-and-performance-of-investment-funds-afg-responds-to-esma-report/>

The CNMV has launched a review of the costs and returns of **Spanish** funds compared with similar funds in other member states. It will investigate whether issues with ESMA's methodology were to blame for the finding that Spanish funds are expensive relative to their EU peers. The CNMV has also identified differences among asset managers with regards to commission practices and therefore intends to issue technical guidance or standards.

The value assessment remedy is the most significant change proposed under the **UK** AMMS remedies.<sup>119</sup> Starting in September 2019, fund managers must assess, at least annually, the value offered by their fund ranges and publish their findings within four months of the fund accounting date.

The FCA prescribes a list of at least seven value assessment criteria on which fund managers are required to reach a conclusion, as well as an overall conclusion of value. The criteria are quality of service, fund performance, manager costs, economies of scale, comparable market rates, comparable services and share classes with different charges.

In its 2019-2020 business plan,<sup>120</sup> the FCA says it will publish summary data on asset manager profitability alongside information on the level of price clustering among UK funds. It will also publish data on "long-term underperforming active funds" after fees to gauge whether increased competition is having an effect on these products.

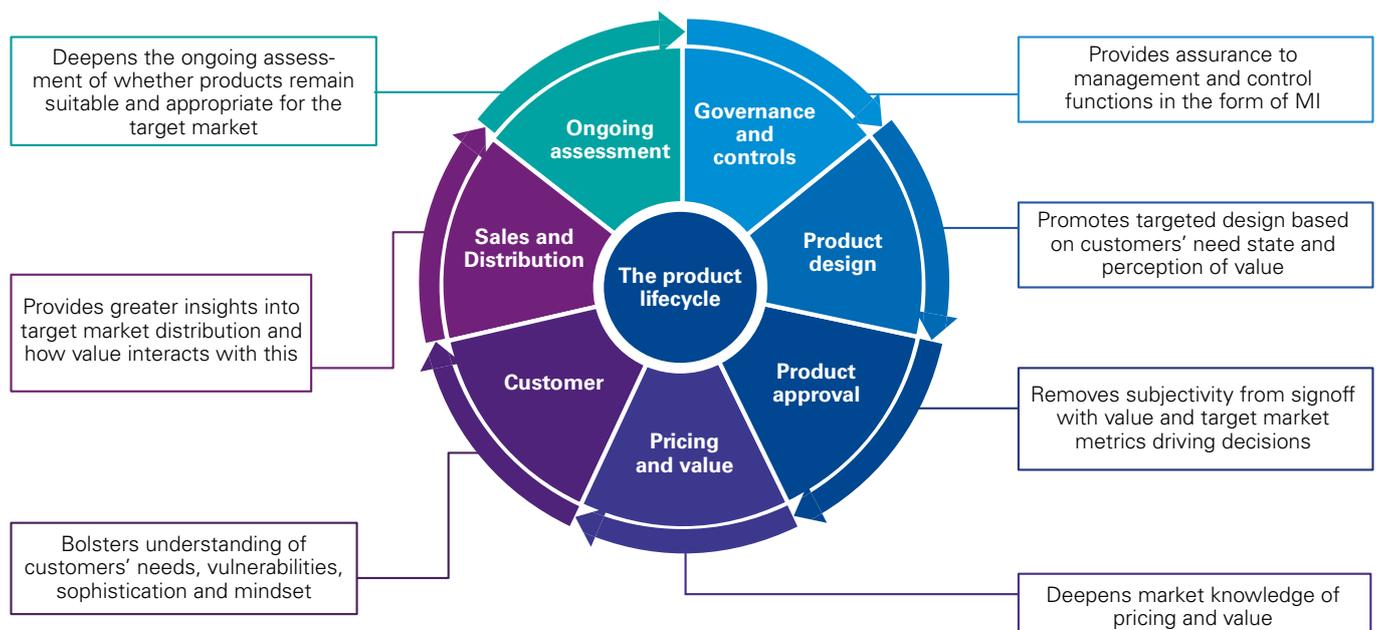
## Value for money extends to retirement savings

The **UK** FCA also launched a consultation to improve outcomes for retirees, including investment options during the drawdown phase and a focus on value for money.<sup>121</sup> After finding a large variation in charges, the FCA said drawdown options need to offer "good value for money", adding that options are often "complex, opaque and hard to compare".

The FCA said firms should provide a one-year charge figure within a "key features illustration", helping pension savers to compare costs more readily. If firms fail to introduce investment pathways with appropriate charge levels, the FCA has not ruled out introducing a cap on drawdown charges.

Another recommendation is that pension savers should receive information from their provider annually, including the actual charges paid, whether or not they are currently drawing an income from their pension fund. The regulator found that some consumers do not receive annual information and even when they do, data on investment returns and annual charges is sometimes missing.

## Value assessment outcomes



<sup>119</sup> <https://www.fca.org.uk/publication/policy/ps18-08.pdf>

<sup>120</sup> <https://www.fca.org.uk/news/press-releases/fca-sets-out-its-priorities-2019-20>

<sup>121</sup> <https://www.fca.org.uk/publications/consultation-papers/cp19-5-retirement-outcomes-review>

## Closet trackers under the magnifying glass

Still under the lens of **EU** regulators are closet tracking funds – funds whose performance mirrors an index, but which are described as actively managed and charge an active management fee. The issue has been a priority for regulators for more than two years, as reported in EAMR 2018. In the **UK** and **Norway**, fund managers have received substantial fines and have been required to compensate investors in funds that effectively tracked a index but that were described as actively-managed.

The **Swedish** government, one of the first to tackle the issue, proposed tougher new rules on disclosures. Fund managers will have to detail how a fund is run, and how it has performed relative to its benchmark – the “active tracking error” – or why comparison with a benchmark is not possible. The information must be displayed on the fund manager’s website and in reports.

In February 2019, the FCA said it was seeking to prevent selective disclosure of benchmarks within fund documentation. **UK** fund managers are now required to explain why and how their funds use particular benchmarks. Alternatively, if they do not use a benchmark, managers should explain how investors can assess the performance of the fund.

The FCA proposes three options of benchmark categories for funds using benchmarks:

- “Constraint,” where a manager constrains how they construct a fund’s portfolio
- “Target,” where a target is used for fund performance
- “Comparator,” where the benchmark is used as a method for investors to compare the fund’s performance

Regardless of the type of benchmark used, the benchmark should be referred to consistently throughout all fund documentation. Past performance should be presented for each fund using a constraint or target benchmark. For funds using multiple benchmarks, the FCA expects past performance to be shown against all benchmarks used. Where fund managers use comparator benchmarks, there is no requirement to show past performance against them.

In addition, the FCA set out how fund managers should describe fund objectives and investment policies to make them more useful to investors. Guidance provides that fund managers should include a description of the investment strategy in the KID or KIID, and that consumer-friendly language should be used.

## Growth of performance fees attracts attention

Performance fees are becoming more popular in some parts of the investment landscape and are attracting regulatory attention.

In **Japan**, the giant Government Pension Investment Fund, for instance, introduced the following new performance-based fee structure in 2018:<sup>123</sup>

- To strengthen alignment of interest, the base fee rate is lowered to the rate of passive funds, and the maximum fee rate is scrapped
- A carry-over is introduced, which partially accumulates payment of annual performance-based fees to link with medium-to long-term investment results
- A multi-year contract enables excess return in the medium-to long-term

### Closet trackers: examples of on-going regulatory activity



In March 2019, ESMA issued a clarification on how managers should present fund performance against a benchmark.



The Central Bank of **Ireland** in December 2018 launched an analysis of Irish UCITS to find potential closet trackers. The Irish regulator said it was examining “2,000-plus” UCITS, using the active share methodology set out by ESMA.



Following its July 2018 contribution to the closet tracking debate,<sup>122</sup> which criticized the methodology used by the European Commission, the **French** AMF is in favor of a pan-EU study to identify closet trackers, but using a different methodology.

<sup>122</sup> [https://www.amf-france.org/en\\_US/Publications/Lettres-et-cahiers/Risques-et-tendances/Archives?docId=workspace%3A%2F%2FSpacesStore%2F07e69596-6cde-448c-bd78-503210e61489](https://www.amf-france.org/en_US/Publications/Lettres-et-cahiers/Risques-et-tendances/Archives?docId=workspace%3A%2F%2FSpacesStore%2F07e69596-6cde-448c-bd78-503210e61489)

<sup>123</sup> <https://www.gpif.go.jp/en/topics/>



Performance fees are becoming more popular in some parts of the investment landscape and are attracting regulatory attention.



BaFin<sup>124</sup> introduced performance fee requirements for UCITS in October 2018. **German** UCITS and funds distributed in Germany are required to calculate performance fees over a year, and the calculation method must include “loss carry forward” and “high water mark” mechanisms, covering at least the last five years.

Applying the requirement to EU funds marketed into Germany has drawn industry criticism. Germany has been accused by industry representatives of potentially damaging the EU single market for funds. It is argued that acceptance by other EU regulators of the extraterritorial effect of national rules would be in violation of the passport principle and would be disruptive to the UCITS framework.

The CBI found multiple failings over the calculation and disclosure of performance fees, suggesting that investors in **Irish** funds may have been overcharged.<sup>125</sup> The regulator, which unveiled its findings in September 2018, analyzed 105 out of the 350 UCITS that charge performance fees and discovered “instances of non-compliance” among one tenth of the funds. Some funds charged performance fees based on gross assets, rather than net assets, while other funds used a benchmark that was not “relevant” to the funds’ investment policy. The CBI also found “inadequate disclosure” in how funds charge performance fees.

The CSSF is also increasing its scrutiny of performance fees. **Luxembourg** does not yet have specific rules or guidelines on performance fees. And further to the AMMS, the FCA clarified that where a performance fee is specified in the prospectus, it must be based on the **UK** fund’s performance after the deduction of all other fees.



<sup>124</sup> Bundesanstalt für Finanzdienstleistungsaufsicht

<sup>125</sup> [https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/industry-letter---thematic-review-of-ucits-performance-fees---4-september-2018.pdf?sfvrsn=2&\\_cldee=YWluZS5tY3BhcnRsYV5Aa3BtZy5pZQ%3d%3d&recipientid=contact-43420910d9d8e711811fe0071b6641b1-42773af8c31d4f689b394d24cc4af33d&esid=999e1dc9-47b0-e811-814f-e0071b6641b1&urlid=0](https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/industry-communications/industry-letter---thematic-review-of-ucits-performance-fees---4-september-2018.pdf?sfvrsn=2&_cldee=YWluZS5tY3BhcnRsYV5Aa3BtZy5pZQ%3d%3d&recipientid=contact-43420910d9d8e711811fe0071b6641b1-42773af8c31d4f689b394d24cc4af33d&esid=999e1dc9-47b0-e811-814f-e0071b6641b1&urlid=0)



## Chapter 5

# Markets: one door closes, another opens

In EAMR 2018 we noted that frictions still existed in the cross-border distribution of investment funds. That remains the case.

Brexit is impacting cross-border flows between the UK and the rest of the EU, and this impact is likely to increase. Meanwhile, the EU regulatory approach to delegation is being more stringently supervised, with US and Asian firms potentially affected, too.

Elsewhere, use of the Asian fund passports remains low, but is slowly rising. Bilateral fund arrangements are flourishing and emerging markets continue to open up their capital markets to foreign firms and investors.

There has also been a flurry of activity in pensions markets, with new opportunities for asset managers and investment funds, but in some cases more conditions or restrictions.

## The EU's evolving approach to third-country asset managers

Brexit will raise barriers to the cross-border distribution of funds and asset management services between the **UK** and the rest of the **EU**, in both directions. The full impact on the sector will largely be delayed, though. If a withdrawal agreement is agreed, there will be a transitional period during which current passports will continue. And in the event of a “no-deal” Brexit, EU and national arrangements have been put in place that will allow the current position to continue, to a greater or lesser extent, for a few months or a few years.

“Third countries” are also confirming their own arrangements with the UK in anticipation of Brexit. **Guernsey, Jersey, Switzerland** and the **US**, for example, have all made key announcements. For more information on developments, see the financial services section of KPMG's Navigating Brexit web pages.<sup>126</sup>

Not all member states are following suit, though. **Ireland**, for instance, has indicated that in the event of no deal, it will not provide “grandfathering” or transition for UK fund management companies of Irish funds.

Meanwhile, the prospect of Brexit has heightened the importance of the review of the different third-country rules in EU legislation. In July 2018, the European Parliament's Committee on Economic and Monetary Affairs set out its position. The key points were:

- A “structured, horizontal and practical framework with guidelines regarding the recognition of third-country supervisory frameworks and a level of granularity of the assessment of such frameworks” should be introduced to improve transparency
- Equivalence decisions should be “objective, proportionate, and risk-sensitive, while upholding the high standards of EU regulation” and should be taken in the best interests of the EU, member states and EU citizens
- Equivalence decisions have a clear political dimension and should be subject to appropriate scrutiny from the European Parliament and Council

Some European voices object to “free” access for third-country firms to EU markets, arguing that the size and resources of US fund management houses, for example, has allowed them to dominate EU markets. MiFID II/MiFIR allow asset managers in the EU to “outsource critical and important functions” to third-country firms, requiring memoranda and equivalence judgements to be in place.

“

... the prospect of Brexit has heightened the importance of the review of the different third country rules in EU legislation.

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During discussions on the new IFD/IFR (see Chapter 3), there was an attempt to replace the current MiFID II/MiFIR provisions by a requirement for third-country firms to register within the EU and abide by EU rules. This amendment was not adopted, but the third-country provisions were strengthened.

ESMA voiced its support for enhanced third-country rules in MiFID II, “facilitating supervision and ensuring a higher level of investor protection.”<sup>127</sup> ESMA's position is that the rules should be the same as in AIFMD. That's to say, more descriptive and prescriptive. It will now have the power to expel an individual third-country firm if there are concerns about its activities.

As regards the AIFMD marketing and managing passports for third-country AIFs and AIFMs, and despite comments by the IMF that the Commission should accelerate the introduction of the third-country passports,<sup>128</sup> there remains no indication that the Commission will activate them soon. Tax considerations are mentioned as issues still being considered, but the view of many commentators is that Brexit is the main factor, given that the UK is a major domicile for both AIFs and AIFMs.

This issue has particular resonance for major alternative fund centers such as the **Cayman Islands** and **Bermuda**, whose regulatory regimes were reviewed over two years ago by ESMA. Bermuda introduced in December 2018 a requirement for private equity and exempted funds to register with the regulator, to position itself favorably for the eventual introduction of the passports. It is currently optional for Cayman private equity funds to be licensed, but the islands might decide on the same approach as Bermuda.

Meanwhile, in April 2019 the European Parliament and Council adopted new legislation that seeks to remove the remaining national barriers to the cross-border distribution of UCITS and AIFs. EFAMA welcomed the move but expressed puzzlement over the rationale behind the requirement for an informal notification by an AIFM to the NCA announcing the start of pre-marketing of an AIF.<sup>129</sup>

<sup>126</sup> <https://home.kpmg/uk/en/home/insights/2018/06/navigating-brexit.html>

<sup>127</sup> [https://www.esma.europa.eu/sites/default/files/library/2018-esma35-36-1442-ipisc\\_uk\\_withdrawal\\_from\\_the\\_eu\\_letter.pdf](https://www.esma.europa.eu/sites/default/files/library/2018-esma35-36-1442-ipisc_uk_withdrawal_from_the_eu_letter.pdf)

<sup>128</sup> <https://www.imf.org/en/search#q=country%20report%202018%2F230&sort=relevancy>

<sup>129</sup> <https://www.efama.org/Pages/EFAMA-welcomes-final-agreement-on-legislation-facilitating-cross-border-distribution-of-funds.aspx>



## Bilateral arrangements grow

**Luxembourg** and **Hong Kong** signed an agreement in January 2019 to streamline fund registration and sales in each other's countries.<sup>130</sup> The CSSF and the SFC signed a mutual recognition of funds (MRF) agreement, which simplifies procedures by which Luxembourg UCITS and Hong Kong public funds are approved in each other's markets.

The memorandum of understanding (MoU) also strengthens regulatory cooperation between Luxembourg and Hong Kong, establishing a framework for exchange of information and regular dialogue between the two financial authorities. The agreement comes hot on the heels of the **Hong Kong-UK** agreement,<sup>131</sup> and the SFC has signed similar agreements with **China**, **France**, the **Netherlands** and **Switzerland**.

The SFC has also signed an MoU on cross-border supervision with BaFin, providing for consultation, cooperation and exchange of information supervision of cross-border activities by regulated entities in Hong Kong and **Germany**.<sup>132</sup>

Meanwhile, Switzerland aspires to give its asset managers better access to EU institutional investors. Given that FinSA and FinIA mirror MiFID II, it is seeking a MiFID II equivalence judgement. The new laws also herald from January 2020 significant changes for foreign firms providing financial services (including investment advice and portfolio management services) to clients in Switzerland.

Foreign firms will be able to provide financial services in Switzerland only if they are entered in a register of advisers. However, they will be exempted from registration if they are prudentially supervised abroad, are part of a financial group which is by law subject to consolidated supervision by FINMA, and provide their services in Switzerland exclusively to professional or institutional clients.

MoUs are flourishing between other parts of the globe, too. **Canada** has recently signed MoUs with **France** and the Abu Dhabi Global Market (ADGM) in the **UAE**, for example.

<sup>130</sup> <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=19PR3>

<sup>131</sup> <https://www.fca.org.uk/news/press-releases/fca-sfc-sign-mou-united-kingdom-hong-kong-mutual-recognition-funds>

<sup>132</sup> <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR60>

## Data barriers

Data protection concerns have raised barriers. The introduction of the **EU** General Data Protection Regulation is a case in point. It has caused issues for EU firms in handing over information on individuals to third-country regulators, including in the **US**.

The European Commission has allowed personal data to flow freely between the EU and **Japan** on the basis of strong protection guarantees.<sup>133</sup> The move, in January 2019, was the final step in the procedure launched in September 2018, and creates the world's largest area of safe data flows. The decision helps investment firms in either jurisdiction to distribute products in the other.

## Asian passports: progress at last?

Outside Europe, the various Asian passporting efforts are slowly gaining traction, with evidence of progress since last year's report.

The SFC says the **China-Hong Kong** MRF scheme is "on track" and "merits further development".<sup>134</sup> The China Securities Regulatory Commission (CSRC) and the SFC have been discussing the approval process for "northbound" Hong Kong funds. This process speeded up in 2018 with at least seven Hong Kong funds being approved.

The CSRC released rules relating to new Mainland pension investment funds. The first of these will adopt a fund-of-funds model and the CSRC has specifically allowed them to invest in Hong Kong funds through the MRF channel. The SFC introduced the open-ended fund company in late 2018 and these funds should soon be eligible for inclusion in the MRF.

The Association of South-East Asian Nations Collective Investment Scheme Framework was set up to facilitate cross-border distribution of investment funds or investment management services, within the region.

Separately, **Australia, Japan** and **Thailand** announced in January 2018 that they would be ready to receive registration applications from February 2019 to use the Asian Region Funds Passport (ARFP), which was set up to provide investors with access to funds from economies throughout the Asia region. The last face-to-face meeting of the Joint Committee of the Passport was held in Seoul, South Korea in early May 2019.

**New Zealand** and **Korea** continue to make progress with the legal and regulatory requirements for implementation required in their jurisdictions. ASIC published seven regulatory guides to provide guidance to the **Australian** funds management industry on changes arising from the ARFP.<sup>136</sup> The guidance provides information on ASIC's decision-making process for registering a managed investment scheme or passport fund, and good practice examples and case studies on a number of compliance issues.

## Other Asia-Pacific market openings

In tandem with the publication of the ARFP guides, ASIC launched a consultation on a modified licensing regime for foreign financial service providers with wholesale clients.<sup>137</sup> Providers holding such a license will be exempt from certain provisions on the basis that there are similar regulatory outcomes achieved through the regime applying to the foreign provider in its home jurisdiction.

In November 2018, MAS announced a private placement program to fund up to USD 5 billion with private equity and infrastructure fund managers.<sup>138</sup> Under the program, MAS will invest in managers who are committed to deepening their existing presence or establishing a significant presence in **Singapore**.

In **Japan**, the Tokyo Metropolitan Government, in collaboration with the national government, private sector and others, took steps to develop the Tokyo asset management community, to attract investment professionals and to nurture investment capabilities. The stated aim was to "win back Tokyo's position as the top global financial city in Asia." A 2018 roadshow promoted "Global Financial City: Tokyo", in conjunction with the Consortium for Japan International Asset Management Center Promotion.<sup>140</sup>

**Hong Kong** has been busy establishing bilateral relations with other fund jurisdictions around the world – examples with European countries are provided above. "ETF Connect" is also on the SFC agenda, which would be interesting to big mainland wealth managers and pension funds wanting to allocate more assets globally. The SFC is working with the CSRC on this.

**China** has continued to open up its markets to foreign asset managers and investors. Beijing said its aim was to "reach out to overseas investors and ensure fair competition between domestic and foreign players."<sup>142</sup> In the space of a few months, China made a number of announcements on its fund sector that could have significant ramifications.

<sup>133</sup> [http://europa.eu/rapid/press-release\\_IP-19-421\\_en.htm](http://europa.eu/rapid/press-release_IP-19-421_en.htm)

<sup>134</sup> <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=18PR108>

<sup>135</sup> <http://fundspassport.apec.org/2019/02/01/the-asia-region-funds-passport-is-live/>

<sup>136</sup> <https://asic.gov.au/regulatory-resources/find-a-document/regulatory-guides/rg-131-funds-management-establishing-and-registering-a-fund/>

<sup>137</sup> <https://asic.gov.au/regulatory-resources/find-a-document/consultation-papers/cp-301-foreign-financial-services-providers/>

<sup>138</sup> <http://www.mas.gov.sg/News-and-Publications/Media-Releases/2018/MAS-to-place-up-to-US5-billion-with-private-equity-and-infrastructure-fund-managers.aspx>

<sup>139</sup> <http://www.mas.gov.sg/News-and-Publications/Media-Releases/2018/Malaysia-and-Singapore-to-set-up-stock-market-trading-link.aspx>

<sup>140</sup> <https://jiam.tokyo/activities/>



## The UAE grows its presence in the domiciled funds space

The Dubai International Financial Centre (DIFC) was set up in 2006, but establishment of funds in the Centre did not initially develop as expected, with fewer than 10 funds established in 2014. Changes in recent years, however, appear to have accelerated this trajectory.

First, in 2010, exempt funds were encouraged to set up. Then, in 2014, Dubai introduced a qualified investor regime with relaxed regulation for larger, more sophisticated investors. The DIFC enacted two new laws in 2018: the Trust Law, which provides an appropriate environment for the operation of trusts in DIFC; and the Foundations Law, a completely new regime to provide greater certainty and flexibility for private wealth management and charitable institutions in line with international best practice.<sup>141</sup>

The effect has been dramatic: the number of funds operating out of the DIFC has now risen to nearly 70, including about 40 qualified investor funds. In addition, many of the world's top wealth and asset managers have established presence in the DIFC. Fund managers from around the world have been attracted to the DIFC, including a sizeable number from south Asia where managers now view the UAE as a viable alternative to other long-standing offshore fund centers. Dubai has also emphasized soft elements of the jurisdiction, such as lifestyle.

ADGM, too, has now started to see an acceleration in fund growth. The Abu Dhabi regulator has hired senior industry professionals from Europe, Asia and the US to provide expertise and networks to expand its offering. As in Dubai, Abu Dhabi has pushed in recent years for investment firms to have a more significant presence on the ground, in line with longer established investment hubs, such as Singapore.

In December 2018, China reduced its “negative list” for market access, with the number of items down to 151 – 177 fewer than in the previous version. For companies looking to enter a Chinese market, the negative list stipulates the relevant procedures, standards, and approvals that need to be attained before access to that market is granted.<sup>143</sup> As a result, foreign asset management companies accelerated their expansion into China's capital market. At the end of 2018, 16 wholly foreign-owned enterprises had obtained licenses to manage private securities investment funds and more than 25 products were registered to issue.



... ensure fair competition between domestic and foreign players.



Then in January 2019, the State Administration of Foreign Exchange raised the Qualified Foreign Institutional Investors (QFII) quota from USD 150 billion to USD 300 billion, and the CSRC published for consultation draft rules on domestic investment management measures under the QFII program. Under the draft rules, foreign investors will be able to invest in more diversified financial instruments such as commodity futures, options, bond repurchase and private equity. The draft rules will also unify the management regulations of QFII and RMB QFII, further facilitating the overseas capital investment and the development of China's derivatives market.

In March 2019, Beijing pledged to relax controls over market access, to shorten the negative list for foreign investment and to permit wholly foreign-funded enterprises to operate in more sectors. Also, the CSRC allowed the IMF to access the country's capital market via the RMB QFII program.

## New fund structures seek to compete

In **Singapore**, the Variable Capital Companies (VCC) Bill was approved in October 2018,<sup>144</sup> providing an alternative structure to complement existing fund structures available in Singapore. New VCCs may be set up as a standalone fund or as an umbrella fund with sub-funds with segregated assets and liabilities. MAS expects to launch the VCC framework in the second half of 2019.

<sup>141</sup> <https://www.difc.ae/newsroom/news/difc-witnesses-continued-growth-regional-centre-world-leading-wealth-and-asset-management-firms/>

<sup>142</sup> [http://www.xinhuanet.com/english/2019-03/11/c\\_137886482.htm](http://www.xinhuanet.com/english/2019-03/11/c_137886482.htm)

<sup>143</sup> <https://www.china-briefing.com/news/chinas-new-negative-list-targets-unified-market-access/>

Advantages for domestic and foreign investment firms include:

- No requirement to disclose a register of shareholders and financial statements to the public
- Not necessary to hold annual general meetings
- The VCC will be able to benefit from Singapore's tax treaties
- Foreign incorporated investment funds may be re-domiciled as VCCs

The law creating **Jersey** Limited Liability Companies (LLCs) will come into force in 2019. LLCs are especially popular in the US, currently accounting for over two-thirds of all new US transparent business structures each year. The Jersey LLC will give US advisers, investors, businesses and fund managers a familiar option for cross-border structuring. It is expected that LLCs will also be allowed to be used for collective investment funds and for funds services business.

Meanwhile, to strengthen **Switzerland's** appeal as a fund domicile, the government streamlined rules governing a new category of Swiss funds, the Limited Qualified Investment Funds, to speed their time to market.

And in **France**, a Decree relating to the new OFS (Organisme de Financement Spécialisé) and modernizing the debt funds framework was published in November 2018. The OFS is a new corporate vehicle that can use the AIFMD passports, is eligible for the "ELTIF"<sup>145</sup> label and benefits from double taxation treaties. The aim is to enhance the financing of companies through investment funds. The decree follows on from the October 2017 ordinance and clarified that companies can use OFSs to borrow.

## Personal pensions in EU get go-ahead

The **European** Council and Parliament finally agreed a deal for the pan-European personal pension (PEPP) product in December 2018 (and ratified it in April 2019), after resolving long-standing differences. Created to encourage European citizens to save for retirement, the PEPP will be Europe's first standardized pension product to be transferable across the EU and could be a significant strategic opportunity for fund managers. It is a flagship policy of the European Commission's CMU initiative.

Before the PEPP is implemented in 2020, EIOPA is required to develop Level two measures that will flesh out the legislation. The one-year time frame, during which consumer testing will also take place, will be challenging. The PEPP default option is likely to cap costs and fees, after the European Parliament insisted a cap is included in the final rules.

Key aspects of the PEPP include:

- PEPPs have the same standard features wherever they are sold
- Savers have the right to switch providers
- Savers can continue to contribute to their PEPP if they move to another member state
- Cross-border distribution of PEPPs is allowed throughout the EU

EFAMA said the PEPP will produce all its "expected positive effects" only if the accompanying Level two regulatory technical standards ensure the product is attractive to both savers and providers.<sup>146</sup> These rules, said EFAMA, as well as national tax treatments of the PEPP, would be "crucial" elements for the product's promotion across member states.

## Other pensions markets develop offerings

Meanwhile, a number of European countries are opening up their pensions markets. Many of these developments, mirrored in countries elsewhere around the globe, are providing new opportunities for asset and fund managers to enter, or more easily to compete in, the retirement savings market. Some developments are giving rise to more conditions or restrictions for asset managers, though.

The **French** market, like many in Europe, has historically been dominated by insurance firms. However, as part of the draft "PACTE" (action plan for business growth and transformation) Bill – which was adopted by the National Assembly in April 2019 – modernization of the pension schemes framework is taking place, in line with the PEPP. This is opening up the retirement products market to asset managers.



... new opportunities for asset and fund managers to enter, or more easily to compete in, the retirement savings market.



On 1 January 2019, with the aim of increasing the overall pool of retirement savings, the **Polish** government introduced a new system of defined contribution (DC) vehicles, known as employee capital plans. The plans can be managed by investment fund companies and will be based on auto enrolment with a government incentive.

<sup>144</sup> <http://www.mas.gov.sg/News-and-Publications/Speeches-and-Monetary-Policy-Statements/Speeches/2018/Variable-Capital-Companies-Bill-2018.aspx>

<sup>145</sup> European long-term investment fund

<sup>146</sup> <https://www.efama.org/Pages/Submitted%20after%202018-03-12T16%2022%2007/Good-news-for-European-consumers--European-Parliament-backs-the-trilogue-agreement-on-PEPP.aspx>

The largest employers (more than 250 employees) must provide these plans by July 2019, and the smallest ones by January 2021. However, the plans are not mandatory for companies that already offer a comparable scheme. Plan contributions will be divided between employer and employee, and both types of contributions will have mandatory and optional parts.

In March 2018, an agreement between the **Norwegian** government and certain public sector unions paved the way for larger asset managers to re-enter the pensions market. Asset managers will be able to compete with the primary public sector pension provider in Norway, but await confirmation that the legislation will make tendering and competition obligatory.

In **Hungary**, the central bank intends to modify the structure of private pension funds, private healthcare funds and retirement insurance products to form compound funds providing all services. Hungary also intends to introduce special government bonds that mature in the year of the retirement of a given client. This will impact asset managers managing retirement funds or the assets of retirement insurance products.

In **Germany**, a new category of pensions was heralded as a potential “golden age” for the industry. The Betriebsrentenstärkungsgesetz, or act to strengthen occupational pensions, came into force in early 2018 and encourages the creation of government-subsidized DC occupational pension plans.<sup>147</sup> The act bans guarantees that were often provided by insurers, allowing asset managers to compete on a more equal footing and allowing pension portfolios to increase their allocations to equities.

However, by February 2019, the new regime had struggled to gain significant traction, with risk aversion by DC scheme members cited as one of the reasons. During a conference in Berlin, BaFin asked unions and employers to start using the scheme. The regulator acknowledged that the lack of investment guarantees could result in “uncertainty,” but noted that the new regime includes safety mechanisms, such as a “buffer” pool in times of increased volatility. If take-up does not improve, mandatory models might be considered.

The CSRC Guidelines for Target Retirement Funds led to 14 **Chinese** asset managers being approved to launch target retirement funds. Currently, China’s retirement plans mostly rely on state- and corporate-sponsored programs. The country is looking to develop target retirement funds, as part of individual retirement plans, amid pressures of an aging society. The launch of target retirement funds are expected also to improve A-share market liquidity.

There has been a widening of **Mexican** pension funds’ ability to invest in foreign mutual funds. They were able to invest in foreign passive funds in 2018, but the regulator announced in early 2019 that this is now extended to foreign actively-managed funds. Investment vehicles must obtain an approval opinion from an independent expert, who must meet certain eligibility criteria. In addition, funds must be registered and supervised by a regulatory authority of “eligible countries for investments”. Moreover, funds using derivatives to increase returns, to leverage or to synthetically replicate an index or benchmark are prohibited, as are ETFs.

<sup>147</sup> <https://translate.google.co.uk/translate?hl=en&sl=de&u=https://kpmg-law.de/en/client-information/arbeitsrechtliche-umsetzungsfragen-zum-betriebsrentenstaerkungsgesetz/&prev=search>



**Brazil** has allowed private equity funds for qualified investors to be fully-invested in overseas assets, and a greater use of master-feeder structures is now permitted. However, pension funds can now invest at most 15 percent in private equity (down from 20 percent), investment can be only via investment funds and, to align interests, the fund manager must itself hold at least 3 percent of the fund.<sup>148</sup> Also, following discoveries of fraud in pension funds via direct real estate investments, pension funds can now invest only via regulated real estate funds.

The DC portion of **Swedish** public pensions, known as the premium pensions system, is undergoing significant changes.<sup>149</sup> All existing agreements were terminated at the end of 2018, and new applications made subject to an approval process which involves due diligence by the regulator, against new and higher requirements. A large number of funds are expected not to meet the new requirements.

Fund managers seeking to operate on the premium pension system marketplace must have at least SEK 500 million outside the platform and cannot offer commissions. In their application, for which they will be charged, they must provide details of the firm's business history and of their funds' performance.

The second stage of the reform is expected to be completed in 2020. The fund marketplace is being transformed into a procured system, where investment options for savers are provided through of an official tender process.

Acceleration in mergers of **Australian** superannuation fund mergers is expected to continue, with fund numbers expected almost to halve over the next five years – a closing door for asset managers. Greater regulatory obligations, coupled with continued increases in operating costs and the churn-out of funds, are placing further pressure on many funds' business models and driving consolidation. As this consolidation leads to increased scale among funds, there is increased internalization of portfolio management.

The **UK** Competition and Markets Authority (CMA) published a consultation notice<sup>150</sup> on the draft Investment Consultancy and Fiduciary Management Market

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Greater regulatory obligations... are placing further pressure on many funds' business models and driving consolidation.

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Investigation Order 2019, following the final CMA report in its market investigation into these services provided to pension funds.

Fiduciary management is defined as comprising one or more of advice on investment strategy, advice on specific investments and investment decision-taking. On the last element, pension fund consultants offering their own investment process compete with third-party asset managers.

The order is designed to prevent adverse effects on competition arising from low levels of pension fund trustee engagement, lack of clear information for trustees on their existing provider arrangements, and lack of clear and comparable information for trustees to assess the value for money of their funds' existing providers.

The CMA's proposals include:

- Requiring the use of a standardized methodology and template for reporting performance of fiduciary management services to potential clients
- Prohibiting pension scheme trustees from receiving investment consultancy services unless the trustees have set strategic objectives for the provider
- Supplying information and documents to the CMA to monitor compliance

Meanwhile, the UK regulators gave the green light to collective defined contribution pension schemes.<sup>151</sup> Such schemes are already offered to workers in the **Netherlands** and **Denmark**, and allow individual pension contributions to be pooled and invested as a single fund, giving members access to better investment opportunities at potentially lower charges.

<sup>148</sup> <https://lavca.org/wp-content/uploads/2018/06/Resolution-n-4.661-25.05.2018-BACEN-002.pdf>

<sup>149</sup> <https://www.pensionsmyndigheten.se/om-pensionsmyndigheten/for-fondbolag/for-fund-managers>

<sup>150</sup> [https://assets.publishing.service.gov.uk/media/5c5db26de5274a31618c4ee3/Draft\\_order\\_for\\_formal\\_consultation.pdf](https://assets.publishing.service.gov.uk/media/5c5db26de5274a31618c4ee3/Draft_order_for_formal_consultation.pdf)

<sup>151</sup> <https://www.fca.org.uk/publication/feedback/fs18-03.pdf>



## Chapter 6

# ESG: investor demands drive institutional behavior

Voices clamoring for climate-aware investing and carbon controls are getting louder. Demand for ethical treatment of employees, customers and other stakeholders is also growing, as is indignation about poorly-managed companies. Consideration of environmental, social and governance (ESG) factors is now a must.

Demand for ESG funds rocketed in 2018 despite difficult market conditions which led to outflows from many other asset types. An industry report found that funds using ESG criteria grew by 34 percent from 2016 to 2018, from USD 22.9 trillion to USD 30.7 trillion, with increases seen across all major regions.<sup>152</sup>

The investor voice is already having a significant impact on asset managers' investment processes and strategies, and regulators in some jurisdictions are seeking to catch up. Not all countries are in agreement, though, with some laws potentially frustrating the adoption of ESG criteria.

<sup>152</sup> [http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR\\_Review2018.3.28.pdf](http://www.gsi-alliance.org/wp-content/uploads/2019/03/GSIR_Review2018.3.28.pdf)

## Regulators flex green muscles

In EAMR 2018 we noted that some regulators were issuing proposals for new rules on ESG. That trend has continued.

In February 2019, IOSCO published a two-month consultation<sup>153</sup> on sustainable finance in emerging markets. It provided an overview of the initiatives that regulators, stock exchanges, policy makers and others key stakeholders in emerging markets have undertaken in this area and set out a number of recommendations:

- Integration by issuers and regulated entities of ESG-specific issues in their overall risk appetite and governance
- ESG-specific disclosures and reporting
- Better data quality
- Definition of eligible activities
- Integration of ESG-specific issues into the investment analysis of institutional investors
- Building capacity and expertise for ESG issues

The May 2018 legislative package proposed by the **European Commission** – see that month’s KPMG Asset Management Regulatory Insights<sup>154</sup> – applies to asset managers, investment funds, investing institutions (including insurance companies and pension funds) and intermediaries. It includes:

- Harmonized criteria (a taxonomy) for determining whether an economic activity is “environmentally-sustainable”
- Disclosure requirements for institutional investors and intermediaries
- The creation of new categories of low-carbon benchmarks

Two elements of the package have already been adopted by the European Parliament and the Council, but discussion on the taxonomy regulation is progressing more slowly. There is clear daylight between the institutions’ positions. For example, the Parliament wants all financial products and all entities, including investee companies, to be in scope,<sup>155</sup> while the Council wants the regulation to apply only to products branded as sustainable investments. The “Level 1” debate now awaits the appointment of the new Parliament and Commissioners, but work on Level 2 MiFID II measures started in January 2019 when the Commission issued draft amendments to MiFID II and IDD.



... a label to encourage retail savers to buy green investments.



ESMA, too, has begun work. Its December 2018 proposals, which were issued as final advice to the Commission in May 2019,<sup>156</sup> included:

- Taking ESG preferences into account when assessing clients’ investment objectives and in product classification
- Requiring UCITS managers and AIFMs to incorporate sustainability risks into their internal procedures and investment processes, and to identify and manage conflicts of interest
- Minimum disclosure requirements on whether and how ESG factors were included in credit ratings

Asset managers will have to set up new controls and potentially hire more staff, ESMA said, noting that firms need to have “sufficient human and technical resources for the assessment of sustainability risks”. Under its enhanced remit (see Chapter 1), ESMA has established a Coordination Network on Sustainability, which will work with NCAs on policy development and integration of sustainability considerations in financial regulations.

In a further move, Vice President Valdis Dombrovskis commented at the Academic Conference on Promoting Sustainable Finance event in Brussels in January 2019 that the Commission was considering introducing a label to encourage retail savers to buy green investments. A further consultation is expected in July 2019.

## Mixed industry reaction to ESG proposals

The Commission’s proposals would impose “prohibitively high” costs on asset managers, making it less attractive to do business in the EU, according to the Alternative Investment Management Association. The Association also commented that imposing the rules “on any activities, notwithstanding whether these are marketed as sustainable... would be disproportionate”.

EFAMA said integrating ESG measures into MiFID II could mean investors are sold unsuitable products. It called for the removal of references to firms having to “ask questions in relation to environmental, social and governance factors” when “collecting information about their clients’ ESG preferences”, on the grounds that ESG preferences should be secondary to a client’s investment and risk preferences.

<sup>153</sup> <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD621.pdf>

<sup>154</sup> <https://home.kpmg/xx/en/home/insights/2016/10/investment-management-regulatory-insights-fs.html>

<sup>155</sup> [http://www.europarl.europa.eu/doceo/document/A-8-2018-0363\\_EN.pdf?redirect](http://www.europarl.europa.eu/doceo/document/A-8-2018-0363_EN.pdf?redirect)

<sup>156</sup> <https://www.esma.europa.eu/press-news/esma-news/esma-submits-technical-advice-sustainable-finance-european-commission>

The Commission's additional demand that asset managers must link their remuneration policies to sustainability risks and targets surprised the industry, as it was not part of the original consultation.

## National responses to ESG vary

The Green Fund designation was developed in July 2018 by the **Guernsey** Financial Services Commission to identify investment vehicles that meet its eligibility criteria for green investing.<sup>157</sup> The Green Fund certification offers a green kite mark if a fund either provides a certificate from an independent third party that the fund prospectus meets the criteria or secures a signed declaration from the fund administrator.

The rules are that 75 percent of assets must be made with the objective of mitigating environmental damage, resulting in a net positive outcome for the environment. The assets must be in a defined set of asset classes including renewable energy, energy efficiency and low-carbon technologies. The remaining 25 percent of assets must not impair the overall objective or be made in a prescribed asset class such as waste landfills, fossil fuels or uranium mining.

In October 2018, **Luxembourg** published its Sustainable Finance Roadmap to lay the groundwork for a comprehensive sustainable finance strategy contributing to the Agenda 2030 and to the objectives of the Paris Agreement. Building on the Luxembourg Green Exchange launched in 2016, Luxembourg also created a legal framework for green covered bonds linked to renewable energy projects.

In **France**, under the PACTE Bill, the AMF will take responsibility for ensuring the quality of information provided by asset managers on their low-carbon strategy and their management of climate change-related risks. While institutional investors must already report on their integration of ESG, they are not required to report their carbon footprint, or their financial exposure to climate risks, and no methodology for measuring the carbon footprint yet exists. In November 2018, the AMF published a roadmap to sustainable finance and created a new Strategy and Sustainable Finance Unit.<sup>158</sup>

The **Swedish** regulator, Finansinspektionen argues that sustainability-related risks and opportunities do not differ from other risks and opportunities linked to financial firms' operations. Sustainability should not be managed in limited areas of corporate governance, the regulator said, but rather be part of corporate governance as a whole.<sup>159</sup>

It conducted a survey in November 2018 of how 67 firms communicate information about integrating sustainability into their governance. The results showed that efforts to integrate sustainability are progressing, but many firms need to work on this area. The regulator observed that it is difficult to interpret how sustainability policies are integrated at an operational level and whether these policies have an effect. It will continue its dialogue with the firms.



We need to catch up to become a leader in a hitherto niche area which will shortly become an important component of mainstream finance.



In **Belgium**, the financial regulator in March 2019 issued a quality standard for ESG investment products. And in the **Netherlands**, one of the AFM's 2019 priorities is sustainability, specifically reporting on sustainable investment products. It intends to take measures if reporting is incorrect, unclear or misleading. The AFM is also analyzing the growing market for sustainable bonds and the risks.

In **Hong Kong**, the SFC said that although much work had been done in facilitating green bonds, other important areas of green finance have been neglected.<sup>160</sup> "We need to catch up to become a leader in a hitherto niche area which will shortly become an important component of mainstream finance", the head of the SFC said in September 2018.

The SFC is now focusing on environmental disclosure by listed companies, because asset managers have said they need quality ESG data to inform investment decisions. **China** is mandating that listed companies make environmental disclosures in 2020. The SFC wishes to act in lockstep.

The SFC is also examining asset managers' integration of ESG factors into investment processes. It is no longer enough, said the SFC, for asset managers to simply say they take ESG factors into account without disclosing a robust methodology to investors. It is further looking at developing consistent disclosure or labeling guidelines for green investment products.

<sup>157</sup> <https://www.weareguernsey.com/news/2018/guernseys-new-green-fund-certification-boosts-a-growing-asset-class/>

<sup>158</sup> [https://www.amf-france.org/en\\_US/Reglementation/Dossiers-thematiques/l-AMF/Plan-strategique-de-l-AMF/Finance-Durable-Quel-Role-pour-le-regulateur-Feuille-de-route-AMF](https://www.amf-france.org/en_US/Reglementation/Dossiers-thematiques/l-AMF/Plan-strategique-de-l-AMF/Finance-Durable-Quel-Role-pour-le-regulateur-Feuille-de-route-AMF)

<sup>159</sup> <https://www.fi.se/en/published/reports/reports/2018/integration-of-sustainability-in-corporate-governance/>

<sup>160</sup> [https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Ashley\\_20180919.pdf](https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Ashley_20180919.pdf)



In the **UAE**, the ADGM unveiled a Sustainable Finance Agenda during a forum held in Abu Dhabi Sustainability Week, in January 2019.<sup>161</sup> It has four aims:

- To become a hub for sustainable finance activities by building sustainability into its regulatory framework
- To create dialogue with local and international government bodies to promote green and sustainable investments in the UAE and regionally
- To commit to increasing the level of knowledge, awareness and acceptance of sustainable finance across the UAE
- To develop a sustainable finance framework within the market and within the products and services it offers

## The investor voice

Institutional investors are applying pressure on asset managers to declare or articulate better how they are integrating ESG factors into their investment process, but are skeptical about regulatory prescription.

In **Germany**, the number of institutional investors that incorporate sustainability into their portfolios is rising but acceptance of ESG is growing more slowly than in other European countries, according to a survey.<sup>162</sup> Some 65 percent take into account sustainability criteria when choosing investments, compared with 48 percent in 2013.

In the **US**, large proxy advisers are encouraging ESG in institutional investment. ISS and Glass Lewis issued new guidelines on gender diversity, environment oversight, director over-boarding and executive compensation.<sup>163</sup> However, other voices in the US are demanding that these and other proxy advisers are reined in, amid concerns that ESG emphasis is reducing the competitiveness of US companies through increased costs and compliance.

Funds investing using ESG criteria are too costly and their targets imprecise, according to a survey of pension funds in **Switzerland**. Around two-thirds of 97 Swiss pension funds surveyed by a Swiss investment advisor said that costs had stopped them investing in ESG strategies. And three-quarters said diverse and unrelated ESG targets put them off. However, over half agreed that ESG could boost performance and reduce risk over the long term.

A pan-European survey by the CFAI sums up the challenge.<sup>164</sup> Most, but by no means all, institutional investors believe sustainability should be incorporated into portfolios. However most, but not all, investors believe that ESG measures should not be mandated.

<sup>161</sup> <https://www.adgm.com/mediacentre/press-releases/adgm-launches-the-sustainable-finance-agenda-to-develop-vibrant-sustainable-finance-and-investments-hub/>

<sup>162</sup> [http://www.union-investment.es/home/Competencies/Responsible-Investment/2017\\_sustainability\\_study.html](http://www.union-investment.es/home/Competencies/Responsible-Investment/2017_sustainability_study.html)

<sup>163</sup> <http://www.canadianminingjournal.com/features/whats-new-for-2019-proxy-season-iss-and-glass-lewis-updates/>

<sup>164</sup> <https://www.cfainstitute.org/advocacy/issues/esg-sustainable-investing>



## Chapter 7

# A word on fintech: the regulators' dilemma

Fintech developments are coming thick and fast. They have already become a powerful external driver of regulation.

The regulators have a dilemma: they are called on to support and help nurture nascent industries that increase efficiency and help consumers to access financial services, but they are concerned about new and heightened risks.

Regulators are rethinking how they regulate the industry – both new fintech entrants and existing businesses that are encompassing fintech developments. Existing conduct rules were largely written in a paper and face-to-face world. Are the rules fit-for-purpose in a digital age?

KPMG's report on the regulation of supervision of fintech<sup>165</sup> describes the regulatory responses to the ever-expanding expectations of external voices – society, consumers and counterparties.

<sup>165</sup> <https://assets.kpmg/content/dam/kpmg/xx/pdf/2019/03/regulation-and-supervision-of-fintech.pdf>

## The impact on asset managers and investment funds

Asset managers and investment funds are caught up in the general wave of fintech-related market and regulatory developments impacting the financial services industry. These include: regulatory concerns around cyber security, data protection and cloud outsourcing; the increasing use of distributed ledger technology (DLT) in payment, clearing and settlement systems; and developments in AI and robo-advice.

On cyber security in particular, regulators are increasingly turning their attention from banks and market infrastructure to asset managers. As well as expecting firms to have appropriately qualified staff, some are requiring the use of an independent expert. Industry bodies are responding to this increased regulatory focus by setting up new working groups and offering bespoke seminars and training sessions.

For example, the **French** AFG released its annual survey of 70 asset managers in October 2018. Half of respondents said cybersecurity was among their top three risks and 35 percent had a dedicated insurance policy (up from 15 percent a year earlier). However, 70 percent still did not have a security operations center and only half declared that they have a named person responsible for information systems security.

The key findings in December 2018 of a cybersecurity review by the FCA of 20 **UK** asset management firms and wholesale banks included:

- Despite growing focus on cybersecurity across financial services, boards and management committees are not familiar with the specific cyber risks their organizations face
- Some risk and compliance functions have limited technical cyber expertise, which results in over-reliance on third-party advisors

### Fintech

“Technologically enabled financial innovation that could result in new business models, applications, processes or products with an associated material effect on financial markets and institutions and the provision of financial services.”

Financial Stability Board

“

... there is a degree of regulatory skepticism over cryptoassets and their underlying technology, DLT.

”

- Many firms did not consider actively how they could incorporate cybersecurity risks into their broader risk approaches

## Harnessing market developments

Three fintech developments, and the regulatory responses to them, are of particular note for fund managers: the use of DLT in processing transactions in fund units or shares; whether cryptoassets are eligible investments and whether “tokens” might replace fund units; and robo-advice.

Governments and regulators worldwide are being urged to help the development of DLT. OECD Secretary General Angel Gurría said in January 2019, at the opening of the OECD’s Blockchain Policy Forum, that governments have a role to play in keeping markets fair and helping new innovations.<sup>166</sup>

A number of national, regional and global fund transaction platforms are being launched, based on DLT. They cover a range of services, including order routing, maintenance of shareholder registers, settlement and payment, real-time transfers of fund shares and reconciliation.

## Cryptoassets: a mixed approach

Amid volatile prices for cryptocurrencies, there is a degree of regulatory skepticism over cryptoassets and their underlying technology, DLT. Responses vary from jurisdiction to jurisdiction to jurisdiction, as evidenced by a recent report by Cambridge University’s Centre for Alternative Finance.<sup>167</sup> Some are moving to treat cryptoassets as financial instruments, others are opposed. This picture was confirmed by the FSB at end-May 2019 and IOSCO is consulting on the regulation of crypto-asset trading platforms.<sup>168</sup>

**UAE** investment funds investing in cryptoassets are regulated as financial instruments by the ADGM regulator, and **Kuwait** has introduced rules on who can deal as primary or secondary. In **Hong Kong**, an SFC statement<sup>169</sup> on the regulatory framework for virtual asset managers, fund distributors and trading platform operators says that

<sup>166</sup> <http://www.oecd.org/about/secretary-general/high-level-panel-blockchain-for-better-policies-paris-september-2018.htm>

<sup>167</sup> [https://www.jbs.cam.ac.uk/fileadmin/user\\_upload/research/centres/alternative-finance/downloads/2019-04-ccaf-global-cryptoasset-regulatory-landscape-study.pdf](https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2019-04-ccaf-global-cryptoasset-regulatory-landscape-study.pdf)

<sup>168</sup> <https://www.iosco.org/news/pdf/IOSCONEW5530.pdf>

## Regulatory and supervisory pressures on firms adopting fintech



only professional investors should be allowed to invest in cryptoassets. And in **Malta**, the Virtual Financial Assets Act requires cryptoassets and cryptoexchanges to be licenced.

The **Jersey** regulator regards cryptoassets as security tokens and the **Guernsey** regulator, while cautious of the risks in crypto funds, has said it is open to approaches and willing to engage with firms on the necessary controls to safeguard investors. Similarly, the **Cypriot** regulator does not preclude applications for AIFs investing in cryptoassets but says they would be assessed on a case-by-case basis.

An ESMA paper<sup>170</sup> in January 2019 found that cryptoassets do not give rise to financial stability issues, but it is concerned that they may pose risks to investor protection and market integrity, and it called for cryptoassets to be classed as financial instruments. It believes that the cross-border nature of cryptoassets calls for an **EU** approach and not differing national rules.

The European Commission is therefore considering legislation to address the need for legal certainty for this emerging asset class in order to ensure investor protection, market integrity and a level regulatory playing field within in the EU. The cryptocurrency exchanges and custodian wallet providers are already “obliged entities” under the 4th EU Anti-money Laundering Directive, but the 5th Directive expressly brings these into scope of the financial crime legislation from January 2020.

Cryptocurrencies should not be directly regulated, but should be ring-fenced from traditional assets, a **French** government report advised.<sup>171</sup> The report said that cryptocurrencies should be allowed to develop, but there should be regulation of trading platforms and investments by asset managers should be restricted. An amendment to the PACTE Bill has made DLT an acceptable means of proving asset ownership, for traditional asset classes and cryptoassets alike. Also, professional investment funds will now be able to invest in cryptoassets registered into a DLT platform.

The **UK** Cryptoassets Taskforce’s assessment<sup>172</sup> of risks and potential benefits concluded that strong action should be taken to address the risks associated with cryptoassets that fall within existing regulatory frameworks, and that further consultation and international coordination are required for cryptoassets that fall outside the existing regulatory framework and pose new challenges to traditional financial regulation. The FCA subsequently issued in January 2019 draft guidance on the classification and treatment of cryptoassets, and how they align to the existing regulatory framework and perimeter.

### AI and robo-advice

Robo-advice is being examined by regulators worldwide as the number of platforms and users increases. The key regulatory concern is that consumers must receive sound advice. Some regulators acknowledge that their supervisory techniques must evolve.

<sup>169</sup> <https://www.opengovasia.com/hong-kong-sfc-sets-new-regulatory-approach-for-virtual-assets/>

<sup>170</sup> [https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391\\_crypto\\_advice.pdf](https://www.esma.europa.eu/sites/default/files/library/esma50-157-1391_crypto_advice.pdf)

<sup>171</sup> <https://www.loc.gov/law/help/cryptocurrency/france.php>

<sup>172</sup> [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/752070/cryptoassets\\_taskforce\\_final\\_report\\_final\\_web.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf)

In **Europe**, the key findings of a report by the ESAs<sup>173</sup> included:

- Automation in financial advice has been growing slowly, with limited firms and customers involved
- The ESAs' original analysis of the risks and advantages of such automation remains unchanged
- Automated financial advice is being offered by established financial intermediaries rather than pure fintech firms
- Given that there has been limited growth and risks have not materialized, no immediate action is necessary, but there will be further work if market size, or the risks it poses, increase

“

... the fundamentals of AI and its underlying risks need to be well-understood and an adequate control framework put in place.

”

The **Luxembourg** CSSF published in December 2018 a white paper on AI, including robo-advice. The regulator is concerned that the fundamentals of AI and its underlying risks need to be well-understood and an adequate control framework put in place. It cautions against robo-advice algorithms that favor investment funds with higher commissions and advises that firms “regularly monitor the effectiveness and appropriateness of the advice provided to avoid mis-selling”.

Digital advisers in **Singapore** are expected to disclose certain information on algorithms, conflicts of interest and a written risk warning statement to clients. MAS has also provided guidance on suitability of advice, asset management and execution of investment transactions.

### At a distance

In recognition that the retail financial sector is increasingly digital, the **European** Commission is consulting until July 2019 on whether the EU Distance Marketing of Financial Services Directive 2002 remains relevant, effective and efficient, and is in line with other EU legislation.<sup>174</sup> The directive aims to protect retail consumers when they sign a contract with a financial services provider in another member state by imposing harmonized rules.

<sup>173</sup> <https://esas-joint-committee.europa.eu/Publications/Reports/JC%202018%2029%20-%20JC%20Report%20on%20automation%20in%20financial%20advice.pdf>

<sup>174</sup> [https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-6079786\\_en](https://ec.europa.eu/info/law/better-regulation/initiatives/ares-2018-6079786_en)



# EAMR abbreviations

<b>ADGM</b>	Abu Dhabi Global Market (UAE)	<b>ETF</b>	exchange-traded fund
<b>AFG</b>	Association Française de la Gestion Financière (France)	<b>ETP</b>	exchange-traded product
<b>AFM</b>	Authority for the Financial Markets (Netherlands)	<b>FCA</b>	Financial Conduct Authority (UK)
<b>AI</b>	artificial intelligence	<b>FinIA</b>	Financial Institutions Act (Switzerland)
<b>AIF</b>	alternative investment fund (EU)	<b>FINMA</b>	Financial Market Supervisory Authority (Switzerland)
<b>AIFM</b>	alternative investment fund manager (EU)	<b>FinSA</b>	Financial Services Act (Switzerland)
<b>AIFMD</b>	Alternative Investment Fund Managers Directive (EU)	<b>FRC</b>	Financial Reporting Council (UK)
<b>AMF</b>	Autorité des Marchés Financiers (France)	<b>FSB</b>	Financial Stability Board
<b>AML</b>	anti-money laundering	<b>IBOR</b>	interbank offered rate
<b>AMMS</b>	Asset Management Market Study (UK)	<b>IDD</b>	Insurance Distribution Directive (EU)
<b>APRA</b>	Australian Prudential Regulatory Authority	<b>IFD</b>	Investment Firm Directive (EU)
<b>ARFP</b>	Asian Region Funds Passport	<b>IFR</b>	Investment Firm Regulation (EU)
<b>ASIC</b>	Australian Securities and Investments Commission	<b>IMF</b>	International Monetary Fund
<b>BaFin</b>	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)	<b>IOSCO</b>	International Organization of Securities Commissions
<b>BEAR</b>	Banking Executive Accountability Regime (Australia)	<b>JFSA</b>	Japanese Financial Services Agency
<b>BIB</b>	basicinformationsblatt (Switzerland)	<b>KIID</b>	key investor information document (EU)
<b>CBI</b>	Central Bank of Ireland	<b>LLC</b>	limited liability company (Jersey)
<b>CFAI</b>	Chartered Financial Analyst Institute	<b>LST</b>	liquidity stress testing
<b>CFT</b>	counter-terrorist financing	<b>MAS</b>	Monetary Authority of Singapore
<b>CFTC</b>	Commodity Futures Trading Commission (US)	<b>MFDA</b>	Mutual Fund Dealers Association of Canada
<b>CMA</b>	Competition and Markets Authority (UK)	<b>MiFID II</b>	Markets in Financial Instruments Directive, revised (EU)
<b>CMU</b>	Capital Markets Union (EU)	<b>MiFIR</b>	Markets in Financial Instruments Regulation (EU)
<b>CNMV</b>	Comisión Nacional del Mercado de Valores (Spain)	<b>MMF</b>	money market fund
<b>CoFI</b>	Conduct of Financial Institutions (South Africa)	<b>MoU</b>	memorandum of understanding
<b>CRM</b>	Client Relationship Model (Canada)	<b>MRF</b>	mutual recognition of funds
<b>CSA</b>	Canadian Securities Administrators	<b>NAV</b>	net asset value
<b>CSRC</b>	China Securities Regulatory Commission	<b>NCA</b>	National Competent Authority (EU)
<b>CSSF</b>	Commission de Surveillance du Secteur Financier (Luxembourg)	<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>DC</b>	defined contribution	<b>OFS</b>	Organisme de Financement Spécialisé (France)
<b>DFIC</b>	Dubai International Financial Centre (UAE)	<b>PEPP</b>	pan-European personal pension
<b>DFSA</b>	Dubai Financial Services Authority (UAE)	<b>PRIIP KID</b>	packaged retail investment and insurance-based products, key information document (EU)
<b>DLT</b>	distributed ledger technology	<b>QFII</b>	Qualified Foreign Institutional Investors (China)
<b>EAMR</b>	Evolving Asset Management Regulation (KPMG)	<b>QFMA</b>	Qatar Financial Markets Authority
<b>EBA</b>	European Banking Authority	<b>RFR</b>	risk free rate
<b>EBRD</b>	European Bank for Reconstruction and Development	<b>SEBI</b>	Securities and Exchange Board of India
<b>ECB</b>	European Central Bank	<b>SEC</b>	Securities and Exchanges Commission (US)
<b>EFAMA</b>	European Fund and Asset Management Association	<b>SFC</b>	Securities and Futures Commission (Hong Kong)
<b>EIOPA</b>	European Insurance and Occupational Pensions Authority	<b>SMCR</b>	Senior Managers and Certification Regime (UK)
<b>ELTIF</b>	European long-term investment fund	<b>SRD II</b>	Shareholder Rights Directive, revised (EU)
<b>ESA</b>	European Supervisory Authority	<b>STRK</b>	Strategia Rozwoju Rynku Kapitałowego/Capital Market Development Strategy (Poland)
<b>ESG</b>	environmental, social and governance	<b>UCITS</b>	undertaking for collective investment in transferable securities (EU)
<b>ESMA</b>	European Securities and Markets Authority	<b>VCC</b>	variable capital company (Singapore)
<b>ESRB</b>	European Systemic Risk Board		

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