

Performance

A triannual topical digest for asset management professionals, issue 5, May 2011



Market buzz

Challenges and opportunities for alternative and long-only asset servicing platforms

Fund administration survey - 2010/2011

Liability Driven Investment

A break for overseas chinese investment seekers?

Managing costs of global mobility programmes

Selection and oversight of service providers to private fund advisers

Tax perspective

Investment management - risk rewards

New tax regulation for investment funds in Germany

External perspective

Global exposure – regulation on target

Spirit of new regulation – The new derivatives order

Using fund shares as collateral will create new distribution opportunities

Decrypting hedge fund indices

Impact Investing – A new asset class or just another hype?

Regulatory angle

Regulatory reform: Winners and losers in the asset management space

Hidden challenges of KII

In this issue



6

20

22

26

28

34

4 **Foreword**

5 **Editorial**

Market buzz

6 Challenges and opportunities for alternative and long-only asset servicing platforms

18 Fund administration survey 2010/2011

22 Liability Driven Investment: a simple approach to a complex problem

26 A break for overseas chinese investment seekers?

28 Managing costs of global mobility programmes by taking a strategic view of international assignments

34 Selection and oversight of service providers to private fund advisers

Tax perspective

42 Investment management - risk rewards

48 New tax regulation for investment funds in Germany

42



48



56



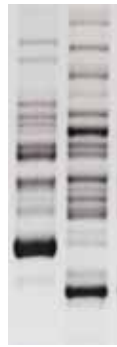
60



70



76



80



86



92



External perspective

- 56 Global exposure – regulation on target
- 60 Spirit of new regulation –
The new derivatives order
- 70 Using fund shares as collateral will create
new distribution opportunities
- 76 Decrypting hedge fund indices
- 80 Impact Investing –
A new asset class or just another hype?

Regulatory angle

- 86 Regulatory reform: Winners and losers in the
asset management space
- 92 Hidden challenges of KII

96 **Latest news**

97 **Hot off the press**

98 **Contacts**

Foreword



Dear investment management practitioners, faithful readers and new-comers of our *Performance* magazine,

In the light of this fifth edition of our digest dedicated to investment management professionals, we would again like to express our thanks to all of the people without whom *Performance* would not be possible. Our gratitude is not exclusively directed to the editorial committee, the Luxembourg and US Marketing departments, the internal and external contributors of the magazine. A special thanks to Uli Grabenwarter, a personal friend since 20 years whose views on 'Impact Investing' are so innovative that we are sure they will generate a lot of debates in our industry. A final, particular thanks goes to you, dear readers, for your feedback and inspiration.



What we already started from the beginning of the *Performance* adventure when building a global magazine for investment management professional actors worldwide, is broadening from one edition to the next. What a pleasure to see our colleagues from Deloitte China, India, Japan, South Korea, Bermuda and Finland joining the ship and contributing to our permanent improvement.

The financial crisis has not spared our industry and rather raised investors' questions on the reliability and performance of asset management. The worldwide economic situation is sending out signals for a risky social cohesion and regulation is the major driver of the industry. We are all aware that the face of investment management is changing through sinking revenues, persistent cost pressures and increasing competitiveness. Asset managers will need to build flexible operating models focussing on operational excellence, business resilience and most important, converging interests between asset managers and investors. Deloitte investment management professionals all over the world will be your partners of choice to assist you in these uncertain times.

In the meantime, we would like to wish you interesting reading of our magazine which, we are sure, will help you to get the big picture of the investment management's reality.

Vincent Gouverneur

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Performance is a triannual electronic magazine that gathers our most important or 'hot topic' articles. The various articles will reflect Deloitte's multidisciplinary approach and combine advisory & consulting, audit, and tax expertise in analysing the latest developments in the industry. Each article will also provide an external expert's or our own perspective on the different challenges and opportunities being faced by the investment management community. As such, the distribution of *Performance* will be broad and we hope to provide insightful and interesting information to all actors and players of the asset servicing and investment management value chains.

Here we are again with our already fifth edition of Performance, Deloitte's digest from investment management experts to professionals of the industry. The positive feedback and growing demand from our readers are still exceeding our expectations and represent our main and essential drivers to pursue our efforts in this edition.

The fifth edition of the magazine will, as usual, cover the most prominent hot topics in the investment management world. The market buzz section is particularly well represented through articles on offshoring trends, a global fund administration survey, overcoming the FX hurdle in China, global mobility and talent programmes and compliance in the private equity world. From a tax perspective, we will learn about tax risk management and changes in the European tax legislation with a focus on Germany.

We are thrilled to present you an external perspective which is stronger than ever. Prominent actors such as Pictet, Lyxor, Thompson Reuters, KBC, Clearstream and State Street bring us most interesting updates on subjects such as hedge funds indices, Liability Driven Investments, the use of investment funds as collateral, global exposure risk under UCITS IV, standardisation of the OTC market, regulatory changes in the custody world and the hidden challenges of the Key Investor Information Document.

Hoping you will have the same pleasure reading these brilliant contributions, we thank you for your permanent support and encourage you to contact me to propose your ideas for publication in a next edition. Dare to be audacious!

Sincerely,

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Challenges and opportunities for alternative and long-only asset servicing platforms

1 Demand for hedge fund administrators is increasing due to the growing institutional investor base and the changing regulatory environment. This is a critical time for administrators to position themselves ahead of the curve and capture market share from competitors.

2 From a long-only perspective, cost rationalisation through offshoring is a known reality for some and an absolute necessity for other actors. We have talked to prominent European asset servicing platforms about their view on the future operating model.



This article aims to picture the challenges and opportunities of, firstly, alternative and, secondly, long-only asset servicing platforms.

1

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Hedge fund administrators: how to capitalise on the growing demands of institutional investment managers

Institutional investors are demanding a wider range of services than traditional high-net-worth investors, and regulatory changes are requiring increased transparency and encouraging the convergence of the custody and administration functions. Enhancing transparency, risk reporting, prime custody and middle office capabilities will be essential to a successful hedge fund administrator in 2011.

The shifting investor base and regulatory environment is driving demand for hedge fund administrators

As we all know, through 2008 and early 2009, the hedge fund sector was rocked, and assets under management tumbled nearly 30% due to fund underperformance and closings. However, over the past 18 months, we have seen a steady recovery of investment in hedge funds and the start-up of new funds.

Most notably, during the late 2009 and 2010 recovery period, a fundamental change in the financial landscape occurred that will benefit Hedge Fund Administrators (HFAs) for years to come. This change led the growth of Assets under Administration (AuA) to outpace that of the hedge fund sector as fund managers outsourced in-house services to third-party administrators. This growth in outsourcing was caused by an increase in institutional investors and a more demanding regulatory environment.

Institutional investors have become an increasingly important investor in the hedge fund sector over the past couple of years and investment will continue to grow in the future. The percentage of assets allocated to the hedge fund sector has been maintained or increased for almost every institutional investor type, and a 2010 survey indicates that institutional support for hedge funds is set to continue to increase in 2011.

This continued rise of institutional investors in the hedge fund universe will increase investor demands for third-party administrators in the coming years.

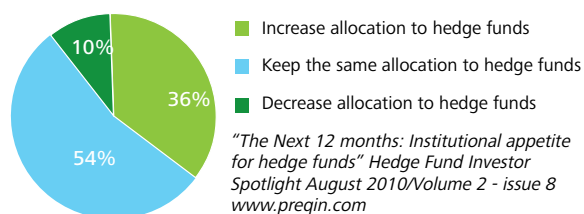
Institutional investors have different requirements from the high-net-worth individuals that have traditionally been hedge funds' primary investors. Institutional investors expect a wider range of services, including 1) cash management, liability management, and custody services to address concerns about counterparty risk, 2) aggregated portfolio risk reporting to provide better transparency and 3) middle office outsourcing solutions to reduce cost and improve fund controls. Growing and developing these product and service offerings will provide an opportunity for administrators to gain a competitive advantage.

The ever-changing regulatory environment is also having a permanent impact on administrator demand.



Chart 1: The percentage of assets allocated to the hedge fund sector has been increased for institutional investors

90% of institutional investors plan to increase or maintain their hedge fund allocations in 2011



The percentage of assets allocated to the hedge fund sector has been maintained or increased for the following institutional investor types

	2009	2010
Public pension funds (~16% of II Universe)	6.0%	7.0%
Endowment plans (~14% of II Universe)	19.0%	20.0%
Private pension plans (~14% of II Universe)	7.0%	9.0%
Family offices (~5% of II Universe)	14.0%	15.0%

Regulations, in the form of the proposed EU Alternative Investment Fund Managers (AIFM) regulations, the Transparency Bill, the UCITS IV jurisdiction, the Dodd-Frank Act, FATCA Tax Reporting, and revised guidelines for global financial reporting are fundamentally impacting the industry, providing even greater impetus for increased transparency and reporting capabilities along with the convergence of the custody and administration functions.

Ultimately, to capitalise on this growing client demand and changing regulatory environment, HFAs must expand their product and service offerings by enhancing:

- Client reporting
- Prime custody
- Middle office services

We will explore each of these in more detail.

Both investors and fund managers need increased transparency and more detailed operational risk reporting

Investors are demanding increased transparency and risk reporting following the global financial crisis and the Madoff scandal, and fund managers have no choice but to embrace this new operating environment as they face increased scrutiny from regulators, central banks and finance ministries. A survey by 'The Hedge Fund Journal' found that 78% of institutional investors claimed "transparency" would be a major challenge for the alternative investment industry over the next three years. Furthermore, 'HFM-Week' specifically cites "increased investor demand for third-party valuation" as a reason for the dramatic growth in hedge fund assets under administration in recent years. Third-party administrators will play a pivotal role in addressing the transparency and operational risk requirements of both the investment manager and investor.

Prior to 2008, only one quarter of U.S. investment managers were outsourcing to third-party administrators. It was typical for managers to price the portfolios themselves and administrators only performed a verification service. In Europe, the use of third-party administrators was more widespread due to the existing regulatory environment. However, investors no longer accept incomplete visibility into managers' portfolio risks and operations and as a consequence third-party administration is a must-have for all top managers, particularly those seeking to capture assets from the growing institutional asset base.

In terms of risk reporting as a service, the role of administrators has become more significant. There is an increased demand for more frequent valuations, as well as greater transparency and information on portfolio and operational risks. Fund administrators need to be able to create NAVs at least twice monthly and, in some cases, on a daily basis. Investors are also asking for regular information on how portfolios are priced and valued. For instance, the administrators' monthly reports to investors now include information on the percentage of the portfolio that is reconciled daily and the proportion of holdings which have been independently priced.

The number of ad-hoc requests from investors relating to queries on portfolio performance has also increased substantially and administrators are continuously developing new reports for investors. In order to ensure that they have tools to automatically develop these report requests and to avoid substantial cost increases, administrators are increasingly turning to technology and web portals that allow investors to pull the information.

In addition, managers will expect their third party administrators to provide them with local intelligence in all the countries where they have existing funds, or wish to distribute new funds, keeping them up to date with local regulatory changes, rules governing distribution, and marketing practices. In Europe, there will be a call for administrators to understand the UCITS IV jurisdiction as well as be able to provide intensive compliance, reporting and transparency requirements for the manager.

Prime custody has become a rapid growth area for the big global banks

The financial crisis of the past few years, including the Lehman Brothers bankruptcy has made diversification of counterparty risk exposure even more critical to fund managers. Managers and their investors are now much more aware of the risk of losing assets or having delayed access to assets. Consequently, prime custody has become a rapid growth area for third-party administrators as hedge fund managers increase their focus on managing counterparty risk. According to the research company Finadium there is a potential \$700 billion market opportunity for the provision of prime custody services (8).

Prime custody is a hybrid service which has been developed by custodian banks and prime brokers to address concerns surrounding counterparty risk. The prime custody service model addresses manager and investor concerns about the safety of assets by enabling the fund to maintain their relationship with a prime broker for leveraged positions such as shorts and derivatives while allowing the administrator to hold the unencumbered assets in a traditional custodial account.



Following the financial crisis, top custodial banks like BNYMellon Corp, JP Morgan and State Street were well positioned to deal with the sudden demand for custodial services, launched their own prime custody offerings and are now reaping significant growth benefits. These banks continue to enhance their products and services to meet their client's increasingly sophisticated risk management requirements. In 2009 State Street rolled out its Enhanced Custody Model (ECM) for hedgefunds. ECM pulls together State Street's

custody and execution services with a securities finance option through its agency lending desk. BNY Mellon also launched a prime custody service in 2009, which is offered through various prime brokers as well as directly to hedge fund clients. It is now the fastest-growing area within AIS and has become a \$120 billion business for the bank since it was launched (9).

Assisting clients in managing counterparty risk will continue to be critical for clients. Global custodial banks must focus on enhancing their systems and processes to ensure they can adapt to the changing regulatory environment and meet their clients' sophisticated risk management requirements.



The opportunity to outsource middle office services to administrators is a growing trend

Outsourcing middle office functions offers fund managers an opportunity to avoid the costs of increasingly complex technology and burdensome regulation as well as to achieve operational cost savings and increased control. As such, many administrators have expanded their middle office capabilities over the past two years, including Citigroup, Citco, HSBC, BNY Mellon, State Street and Apex Fund Services (Source 6). The Middle Office function links trade information between hedge funds, executing brokers, and prime brokers/custodians.

The trend of outsourcing middle office services has been driven by institutional investors who are used to asset managers using third-party service vendors to provide independence to the relationship. The outsourcing of middle office functions improves the control environment of the fund, assists in managing operational risk and allows investors visibility into trade activity.

The middle office component can also provide opportunities for cross selling of other services within the global custodial banks in areas such as cash and collateral management and risk reporting.

Overall, HFAs that position themselves ahead of the curve in terms of offering a broader array of products, services and leading technology platforms will have the ability to respond to growing investor demands and to capture market share from competitors.

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Long-only asset servicing platforms: how to create value and generate revenues in the fund management industry

With €7,728 billions in asset under management as at end September 2010 and more than 52,831 different funds (UCITS and non-UCITS) (source: EFAMA), Europe represents a significant portion of the worldwide investment management industry as a whole. While the fund management industry has followed a strong streamlining and standardisation trend, it should be noted that the transaction processing volume has strongly increased and remains very labour-intensive. This reason had already triggered an offshoring phenomenon more than a decade ago, causing some companies to offshore parts of their activities. Today, the recent turmoil in the finance industry has brought the already existing need for cost rationalisation to the next level. Now that trading activity is increasing again, creating a need for more resources, it seems that offshoring, already a reality for some actors, is becoming a genuine necessity for others. We met with some of the most prominent European asset servicing providers with previous offshoring experiences, clients of those asset servicing providers and their own service providers, in order to better understand the rationale behind this phenomenon.

Outsourcing vs. offshoring: setting the scene

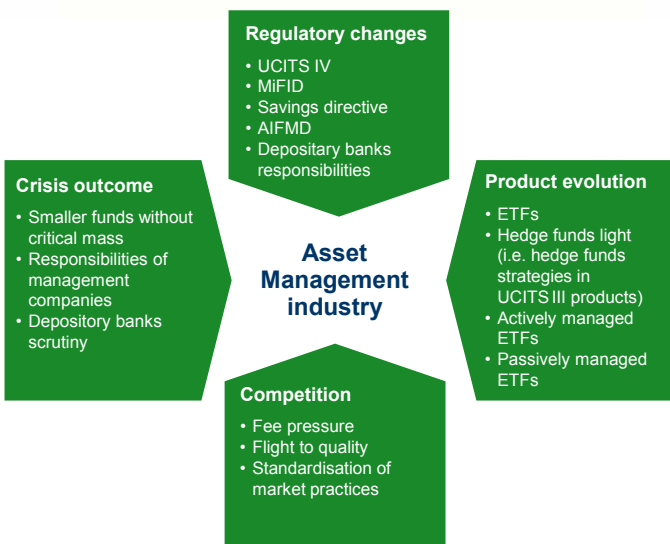
Even if outsourcing and offshoring are usually mistakenly referred to as the same exercise, an important distinction has to be made:

1. **Outsourcing** is an option chosen by companies without the necessary critical mass, expertise, resources or IT infrastructure to manage the full range of their activities in-house. As a result these actors would choose to outsource the activities that they are not in a position or do not wish to support to a service provider becoming the *insourcer*. One of the key aims of outsourcing is to allow the actor to focus and develop its core activities (e.g. investment management).
2. **Offshoring** would be the option chosen by an insourcing asset servicing actor to mainly reduce high HR and IT costs driven by labour-intensive operations.

Even if the complexity of the offshored activities varies from one actor to another, we have mainly observed two distinct models: the first one consists in offshoring the preparation and processing processes while keeping the controls and validation onshore; the second consists in offshoring the complete processing and validation process of a specific task. Both models have strong



Forces at work in the asset management industry...



...result in new challenges and opportunities



prerequisites: for the first, significant teams need to remain onshore to ensure the continuity of the activities. The second model, being knowledge-intensive, requires both parties to engage in a long-term relationship.

Cost reduction and access to resources are key drivers, but centralisation of activities should not be underestimated

Back in the 2000s, the main driver for outsourcing was not solely the widely spread cost reduction factor; almost equally as important was the need for resources at a time when service providers were looking for a solution to cope with the high volumes and sharp growth of activity.

For some actors, the group strategy to create centres of competence for specific functions (e.g. pricing) had been a decisive factor. The objective of these actors was to set up operational centres requiring a certain level of expertise from their staff and enabling global group synergies.


As a result, those centres have not necessarily been set up in low-labour-cost locations but in a branch of the group which may be located in other Western countries such as Germany or Ireland.

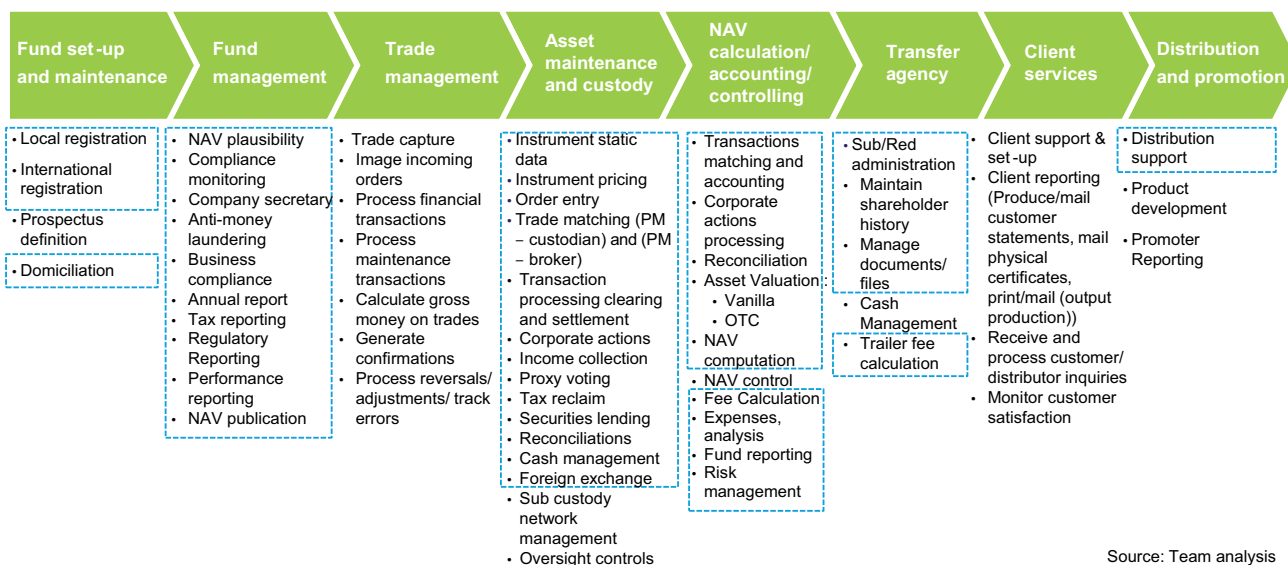
The outcome of this centralisation can be observed at different levels: the group can mutualise the cost for a dedicated function, maximise synergies and this time financial benefits are gained through streamlined processes, improved operational efficiency and reduced IT costs instead of employing less expensive human resources.

'Offshoring actors' will not only seek resourcing and resilience capacities but have also come to adopt a strategy to leverage existing group wide operational centres in order to consolidate specific activities in one centre of competence.

ILLUSTRATIVE

Many possibilities exist when selecting activities to offshore...

 Activities outsourced or offshored on the market



Source: Team analysis

Follow-the-sun approach: another driver in some actors' service strategy

The will to offer a 24-hour-service has become increasingly important. Indeed, third-party service providers are more and more frequently required to support international clients, including those who are in a different time zone, and cover markets from all worldwide regions. As a result of the need to be close to clients and able to produce real time data (e.g. as soon as the different markets close), combined with difficulties in hiring night-shift employees, some actors decided to offshore processes to locations in different world regions where they can more easily set up night-shift teams or cover different time zones.

'Pure' data processing activities are the target candidates for offshoring

The most common activities offshored by the surveyed participants are:

- Reconciliation
- NAV computation preparation
- Trade processing
- Some TA activities

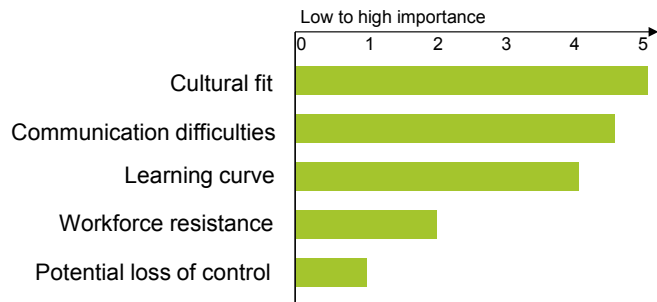
In other words, the most commonly offshored processes are more 'data processing' oriented rather than exceptional or core oriented.

Typically, all expert, specific, creative and client-facing functions will remain onshore as they constitute core activities.

Offshoring is an exercise full of challenges

According to a recent survey performed by Deloitte in 2010, at the top of the list of the key challenges encountered by offshoring actors is the cultural fit. Wherever the offshoring location, the surveyed participants explained that this factor should not be underestimated as it has been in some cases.

Main challenges faced by the offshorers



Strong governance and project management are essential to ensure a successful offshoring exercise

Five main risk mitigation solutions can be identified:

- 1. Governance and project management:** Establish solid ongoing governance and project management structure with clear issue management and resolution processes; develop a solid business case upfront and clearly define performance measures and service level specifications that are tied to business results, and re-evaluate those measures at regular intervals as the relationship evolves
- 2. Organisation:** Thoroughly define roles, responsibilities and skill set requirements prior to go-live (e.g. manager, employee, business partner, centres of excellence, performance manager)
- 3. Change management:** Identify resistance at an early stage of the project and implement change programmes to maximise outsourcing benefits; define realistic expectations as to what employees can expect, and communicate clearly and regularly; ensure that a robust business case is developed at the onset and on an ongoing basis, maintain buy-in of key stakeholders around the benefits of the project
- 4. Resources management:** Do not underestimate the amount of time and resources needed to change people's cultural and operational mindset; define the skill sets required for the retained HR organisation in order to create a strong strategic focus; use all available recruitment channels including newspapers, internet, agency and campus recruitment events
- 5. Process definition:** Process owners and customers need to drive the definition of performance; gain agreement on the newly redesigned global and local processes by involving a wide range of stakeholders in the design and sign-off of the processes; involve legal counsel to confirm local process changes are required for compliance

What's next for the European fund servicing industry?

The largest service providers could position themselves as leaders in many areas. In the current economic context, some countries, such as Luxembourg or Ireland, offer a unique concentration of investment fund industry experts in all aspects of product development, administration and distribution, which allows those types of location to remain attractive and competitive.

Nevertheless, the new offshoring reality could lead those influential actors to review their operating models and remain on top of the fund industry by leveraging on the following added-value factors:

Renowned UCITS brand: registration, global distribution and promotion of UCITS funds have, for many years, been the leading product for cross-border and global fund distribution. Many leading cross-border fund management groups use expert locations' UCITS platforms for their global distribution strategies.

Within the EU, UCITS funds benefit from the passport arrangements available under the UCITS directives and thus can be publicly marketed within all member states, subject to the 'notification' process in each member state.

Moreover, in addition to the reporting obligations contained in the UCITS Directive, UCITS funds will often be required to satisfy the local regulations governing marketing and advertising in each country of distribution.

Outside the EU, UCITS funds must satisfy the regulatory framework governing public distribution of foreign funds in each intended jurisdiction. However, the UCITS brand is well recognised and accepted as having high levels of consumer protection, risk diversification and management and overall governance. In many jurisdictions, this acceptance is formally incorporated into local regulations meaning that UCITS funds have a 'lighter' authorisation process than is the case for non-UCITS equivalent investment funds.

Onshore locations as product development platforms

European member states, such as Luxembourg and Ireland, gained extensive experience in technical investment fund solutions such as multiple share classes and pooling and expertise in special products such as hedge funds, pension funds and alternative funds.

These onshore locations could seek to leverage this expertise by creating a global product development platform offering innovative products to the global fund industry.

One could imagine these onshore platforms taking care of the inception and initial maintenance of new products over a certain time after further handing over the administration to offshore centres in order to allow onshore centres to concentrate on developing and creating new products.

One face to clients

Even when a considerable part of activities are offshored, it seems essential for onshore locations to remain in charge of the relationship with clients, acting as a 'management cockpit'. Maintaining the client servicing function in the onshore location has two main advantages:

- Remaining close to clients
- Expertise and knowledge of the products

Specialised services

The level of services that is requested from third-party fund administrators is increasingly specialised, which results in a growing trend toward offshoring more complex activities as well.

Onshore locations should consider rather concentrating their efforts on providing specialised services to their clients while offshoring the less-added-value functions.

These locations have a strong expertise and added-value potential in the following areas of asset servicing:

- Corporate and investment Compliance functions
- Global transfer agency
- Financial reporting
- Middle office
- Corporate actions
- Risk management
- Collateral management
- Third-party funds client servicing



Fund administration survey 2010/2011

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Introduction

The continued institutionalisation of the investment industry coupled with a shifting investor base has resulted in an increased demand for higher standards of administration services, but what do administrators see as the key challenges in reaching those standards?

To find out, Deloitte recently undertook a survey of third-party fund administrators around the world. This is the fourth time such a survey has been conducted; however, in previous years the survey was focused on European administrators. This is the first time we have included administrators in North America and the Caribbean.

Responses were received from a total of 71 administrators, based in 11 countries. The geographical split of respondents is shown in figure 1.

What do administrators see as the key challenges in reaching the higher standards of services?

Although all respondents provide third-party fund administration services, the profile of respondents' businesses is quite varied, with 13% of respondents administering less than \$1 billion of assets, 35% between \$1 billion and \$10 billion and 52% with over \$10 billion of assets under administration.

The issues

We asked participants to identify the key industry issues facing their business and the results are shown in figure 2.

Regulation

It is clear that irrespective of the geographical location or size of the respondent, the single biggest issue facing the industry as a whole is regulatory change, with 65% of respondents identifying this as their greatest challenge.

Given the raft of new and prospective regulations, it is no surprise to us that this has been identified as the greatest challenge.

The EU Alternative Investment Fund Managers Directive (AIFMD) generated significant debate as it went through the EU parliamentary approval process in late 2010, and the industry awaits the level 2 measures towards the end of 2011. 'Offshore' respondents (based in Cayman, Guernsey, Jersey, Bermuda and the Isle of Man) were twice as likely to see the AIFMD having a significant impact on their business as respondents in 'onshore' jurisdictions.

Other new regulations set to impact the industry, namely the roll out of UCITS IV and the SEC Custody Rules, are not seen as significant developments for the Administration community, although they are undoubtedly significant issues for asset managers and perhaps as the specific requirements of both become clearer administrators will need to stay abreast of changes in their clients requirements. This is also true for FATCA which is likely to present significant challenges to all participants.

Other challenges

While regulation is the clear number one issue facing administrators today, the above table shows there are a series of other pressures which are squeezing administrators and are also seen as significant for over 40% of respondents. All of these issues are linked.

Service quality and technology

When the markets crashed in 2008 and 2009 many administrators felt the impact quite severely. As assets under administration fell so too did administration fees, which were largely based on a percentage of those assets. Administrators had built a cost base to service higher levels of assets, and some difficult decisions had to be made. In many cases headcounts had to be reduced. However, the

Figure 1: Geographical split of respondents

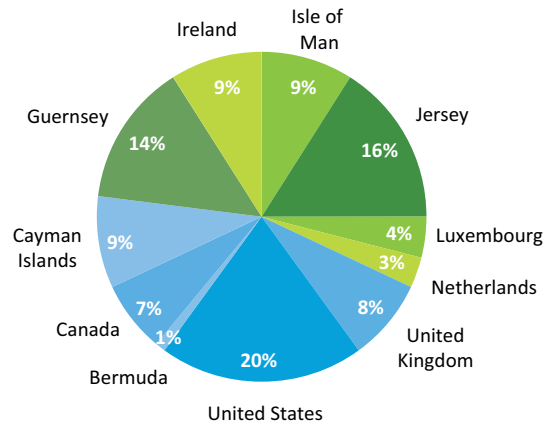


Figure 2: Key industry issues

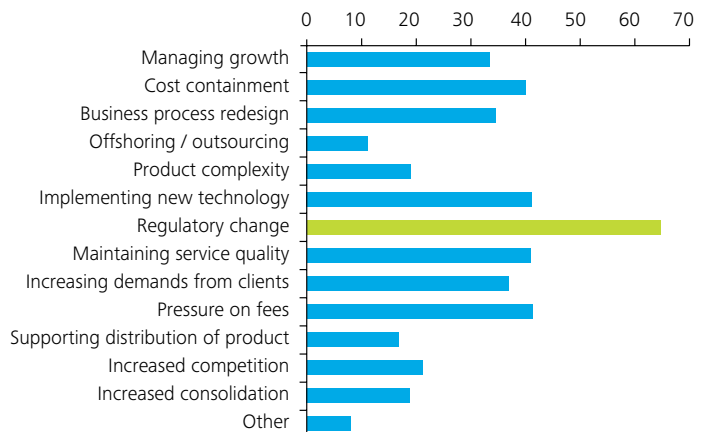
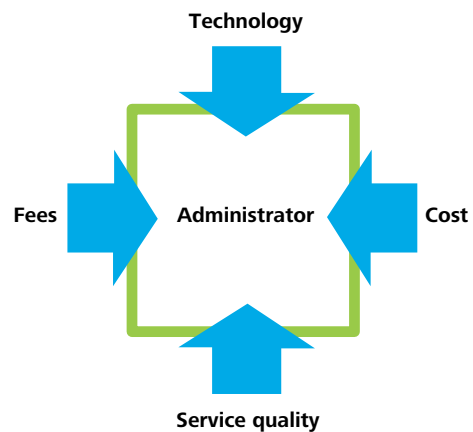


Figure 3: Other challenges





The services administrators are being asked to provide by their clients are also changing with the new investor model, with more demand for middle office services, risk reporting and an increased level of transparency.

workload of an administrator did not decrease just because the assets under administration had diminished and more efficient, innovative servicing models were required in order to maintain quality levels often involving more streamlined processes and the efficient use of IT.

The services that administrators are being asked to provide by their clients are also changing with the new investor model, with more demand for middle office services, risk reporting and an increased level of transparency. These services will in time become core services, and administrators will need to continue to innovate and provide those additional services in order to maintain their service levels.

Fee pressure

Whilst some 'normality' has returned to the markets—indeed, in the alternatives area Deutsche Bank recently forecast record inflows into the asset classes—administrators still need to be innovative in their service models to service their clients, with fees being reduced in many cases. The administration market remains very competitive and while only one in five administrators view increased competition as a major issue, a similar amount see industry consolidation as a significant issue. For every merger of administrators, there is a new entrant to the market and the market remains competitive.

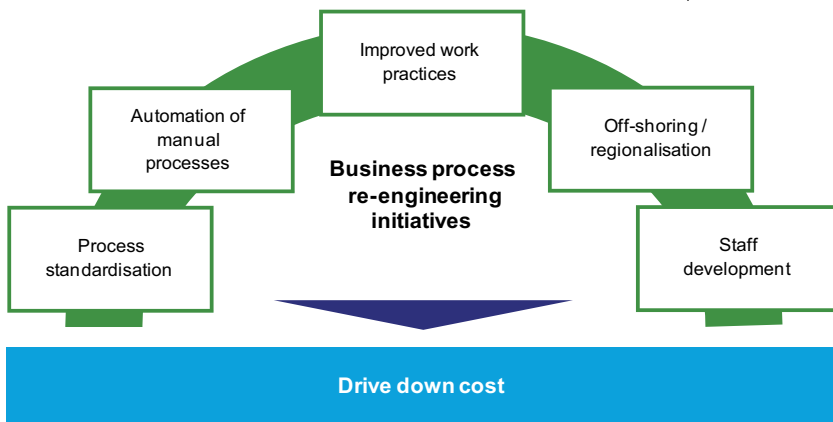
To address the issue of fee pressure, we asked administrators if they saw any changes to fee models in the future. One in three administrators responded that they would look to charge separately for 'add-on' services and we have seen a move to more detailed service level agreements setting out what constitutes core administration services. 20% of respondents envisaged an increase in minimum fees—although this will be something to discuss with their clients.

Notwithstanding the identified fee pressures, 95% of respondents predicted positive revenue growth in their business in 2011, which is a reflection of the anticipated growth in assets under administration and a very positive endorsement of the asset servicing industries' prospects moving forward.

Costs

If fees continue to be squeezed, administrators need to continue to look at their cost base, and our survey shows some ambitious cost management programmes being implemented in 2011, with 40% of administrators looking to take 6-10% out of their cost base and 20% looking to cut more than 10% (indeed 5% are looking to cut in excess of 20%!).

So what initiatives are administrators employing to achieve this?

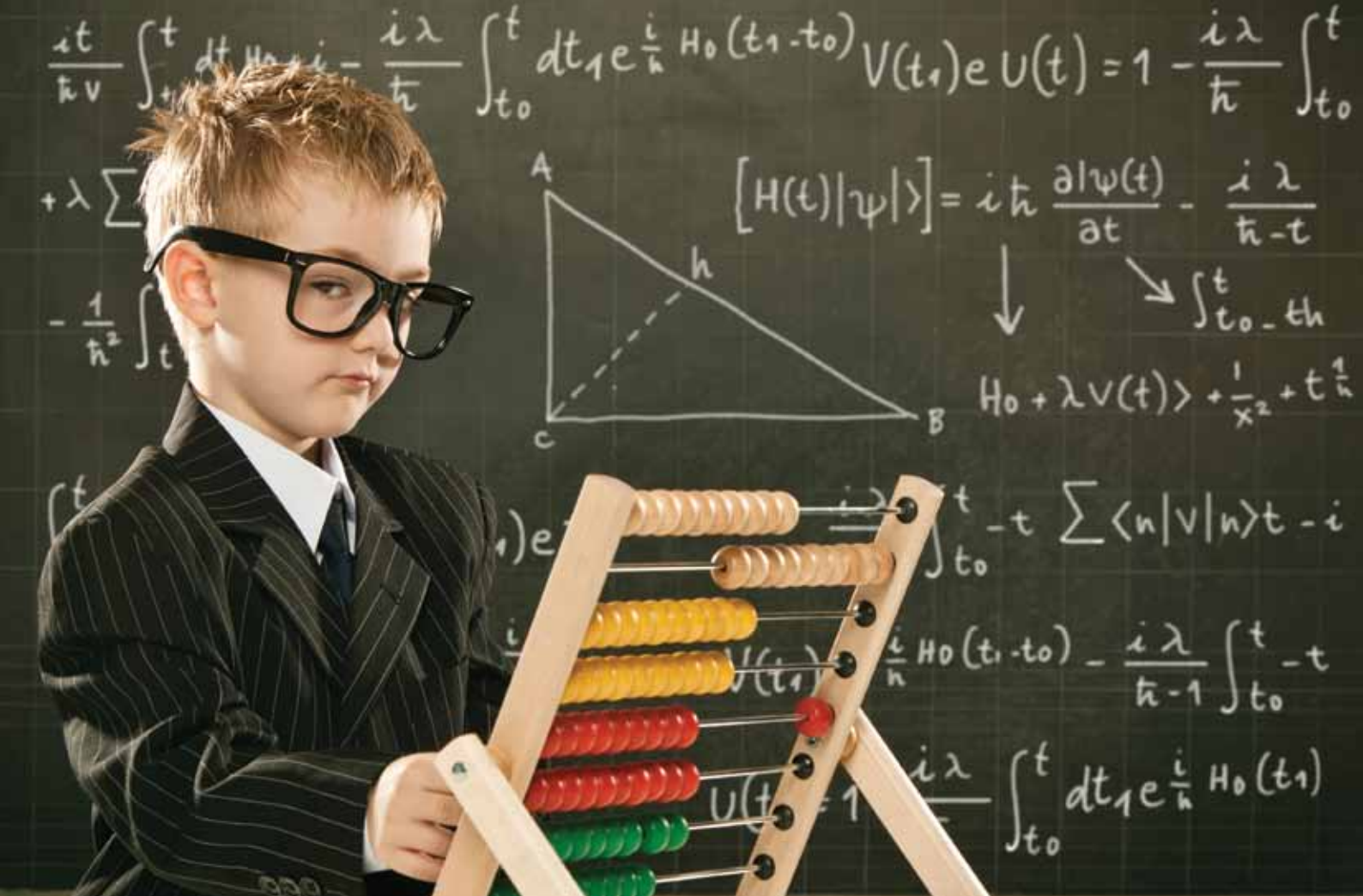


A majority of administrators have made significant progress in the areas of staff development and process standardisation, but over 45% of respondents intend to invest significantly in the automation of manual processes in an attempt to drive down costs, manage operational risk and provide the enhanced services sought by their clients.

Summary

No one can deny that the administration industry has faced some significant challenges over the last number of years and that additional challenges await the industry in the future. Administrators will be forced to continue to innovate and develop their service offerings so as to address the needs of their clients and comply with the new regulatory regimes as they come into force. They will do so in the face of ongoing pressure on fees, although some flexibility in the basis of fee charging is anticipated, alongside some growth with the expected rebound in assets under administration.

That 95% of respondents expect revenue growth in 2011 is a hugely positive statement of intent from the administration industry to meet these new challenges head on and to continue evolving in order to meet the new demands placed on them.



Liability Driven Investment: a simple approach to a complex problem¹

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Liability Driven Investment (LDI) is often too fuzzy a concept to provide guidance in real life investment scenarios. However, if clear objectives are identified and agreed upon it is possible to build a consistent investment process.

¹ This article summarises the Lyxor white paper 'Liability Driven Investment' from the same authors, available on the Lyxor website.

The recent financial crisis challenged the consensus on long-term investing

Liability Driven Investment and Asset Liability Management (ALM) refer to situations in which investors must monitor the difference between their assets and their liabilities. Conversely, asset management refers to managing assets with no reference to liabilities. As it is unlikely that an investor has no liabilities at all, most real-world investment situations can be categorised as Liability Driven Investment.

Unfortunately, unlike asset allocation, which offers quite a well-established framework, LDI and ALM cannot refer to any well-identified theoretical body. As such, most financial institutions are forced to make their own way through the interactions between asset allocation and liability hedging within an ever-changing accounting and prudential environment.

Despite this absence of a theoretical body, a soft consensus has emerged that LDI and ALM might not be of such practical importance. Long-term statistics, supported by decades of growth in stock markets, have shown that historically, equities would always perform in the long run, typically over eight years. However, this was not shown in the very specific case of Japanese equities. Historically, a well-balanced equity portfolio would always outperform fixed-income liabilities. Liability hedging could therefore only appear as a costly, unnecessary solution. Institutions therefore focused more on their long-run asset allocation and separated that matter from changes in their liabilities. Based on the literature regarding long-run investments, most strategies have converged towards a balanced, constant-mix portfolio approach. The equity exposure was essentially country-driven, depending on the local financial culture.

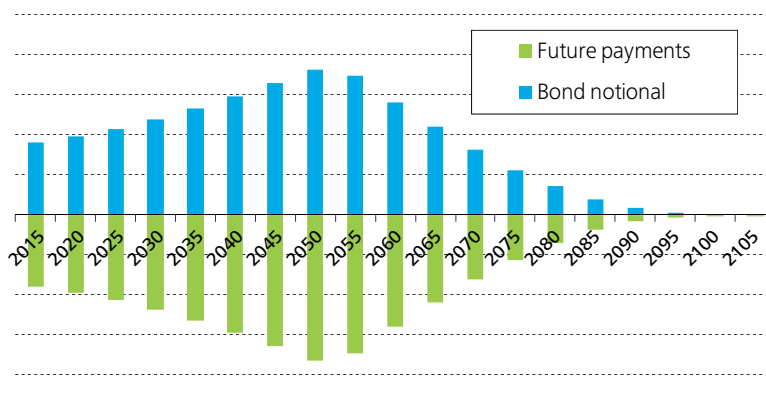
Some years ago, due to the constant decrease in interest rates, many institutions realised that investing had become more difficult, as more 'alpha' was needed to 'cover' unhedged liabilities. Another analysis would be to acknowledge that because liabilities were not hedged, the necessary returns on the asset side varied over time. By offering seemingly low risk and steady yields, hedge funds as well as structured credit products appeared to be the right solution to face this combination of decreasing interest rates and an unhedged institutional gap.

Unfortunately, the dislocation of part of the hedge fund industry, the major crisis suffered by securitisation products as well as the widespread drawdown on equity markets has cast doubt on this consensus. Firstly, the risk of long-term poor equity returns appears to be real. Secondly, hedging issues can no longer be hidden by the alpha quest and need to be addressed thoroughly. Thirdly, market acceleration illustrates both the necessity of addressing volatility as a specific risk and considering governance structures capable of correctly handling dynamic investment strategies.

Liability risk has a market price and can be hedged

From our point of view, the important matter is not whether the investment policy performs in absolute terms, but the behaviour of the strategy with respect to the liabilities. Following this perspective, there is only one time-consistent liability valuation method. Actuarial methods can produce good estimates for future payment amounts. From these estimates, future payments can be closely replicated by a liability hedging portfolio, essentially cancelling out the liability risks. Typically, this can be achieved with bonds, of which maturities correspond to future payments, as illustrated in figure 1. These bonds may be inflation-linked, depending on whether the liability payments are indexed on inflation. The present value of the liabilities is defined without ambiguity as their buyout price, i.e. the current value of the liability hedging portfolio.

Figure 1: Bond portfolio matching liability payments



Such strategies have been criticised as being entirely invested in bonds, thus missing superior equities or hedge fund returns. However, hedging interest rates does not exclude other investments. In fact, a liability hedging strategy can also be achieved using an interest rate swap contract and an inflation rate swap contract. Entering into these swap contracts fixes the funding gap of the investor at its current level, eliminating the unrewarding interest rate and inflation risks. Together with short-term fixed income investment, this constitutes the risk-minimising investment policy. On the other hand, equity or hedge fund investments mixed with liability hedging swaps only expose the investor to rewarding risks.

With properly hedged liabilities, LDI becomes standard asset management

With a proper liability hedging policy, the source of rewarding risks does not need to be related to the liability structure. Optimal investment simply maximises expected returns for a given absolute risk level. Given the accepted risk level, optimal allocation can be derived from standard asset management techniques such as diversification, alpha and beta exposure. Nevertheless, the total risk budgeting remains a specific choice, related to the constraints and objectives of the investor.

Using all of those elements, plans to bridge possible deficits can be developed. Some risk level must be accepted, in order to achieve sufficient excess returns of the assets over the liabilities. In practice, the proportions of equity-like investments have to be fixed. In general, investors choose the constant mix that matches their return objectives in the long term. However, these return objectives are given from their present situation. When equity prices underperform their expected return, this type of investment policy faces two challenges: larger returns are needed to bridge the extended funding gap, but increasing risks may lead to a worsening of the situation. Either way, after a possible long reflection period, the investor would change his risk profile and long run policy. This causes a source of inconsistency as 'long run policies' are being changed every year depending on asset returns. Our goal is to build strategies that are consistent in the long run with any future outcome.

Clear objectives on future funding ratios leads to consistent asset allocation

To achieve this goal, we need to choose an explicit Key Performance Indicator (KPI) to be able to design adapted portfolio strategies. For example, the funding ratio (i.e. ratio between assets and liabilities) or the funding gap (i.e. the difference between assets and liabilities) can be considered. Investors should set a clear objective for this KPI, such as cancelling out the deficits, and also impose a minimum acceptable KPI value in order to control the losses in worst-case scenarios. The investment period during which the objectives are expected to be reached, i.e. the time horizon of the strategy, must also be defined. Indeed, a strategy needs to be more aggressive if the objectives have to be reached quickly. Note that this objective horizon should be distinguished from the term of the liabilities. Such clear objectives lead to a well posed problem that can be handled with modern finance theory. The whole asset allocation process is summarised in figure 2.

Within this framework, an optimal strategy can be found. This strategy will be the most adapted to the objectives and constraints. In particular, only rewarding risks are taken, for the sake of efficiency. These strategies constantly adapt the quantity of necessary risks to the present situation in a consistent and predictable manner. For example, when the objective has been reached, no more risks will be taken, as they are no longer required. The same funding level will be maintained until the investment horizon, thus achieving the objective in every case. As we give up the possibilities of performing significantly above the objective, we greatly increase the probability of reaching it. On the other hand, when the funding gap approaches unacceptable levels, the exposure is reduced in order to control maximum losses in worst case scenarios. This is illustrated in figure 3. These strategies lead to tightened funding ratio ranges at the investment horizon. In particular, IAS 19 charges are very low compared to classical practices, thanks to efficient risk budgeting.

Figure 2: Investment process

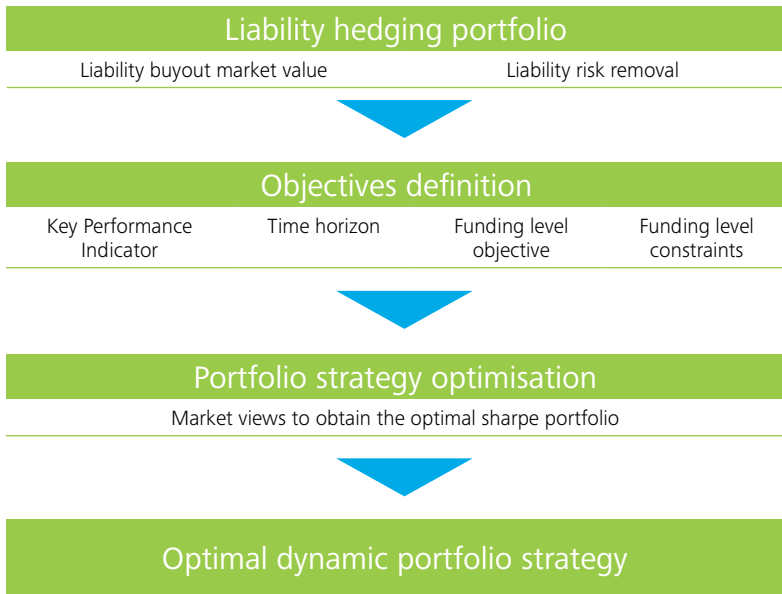
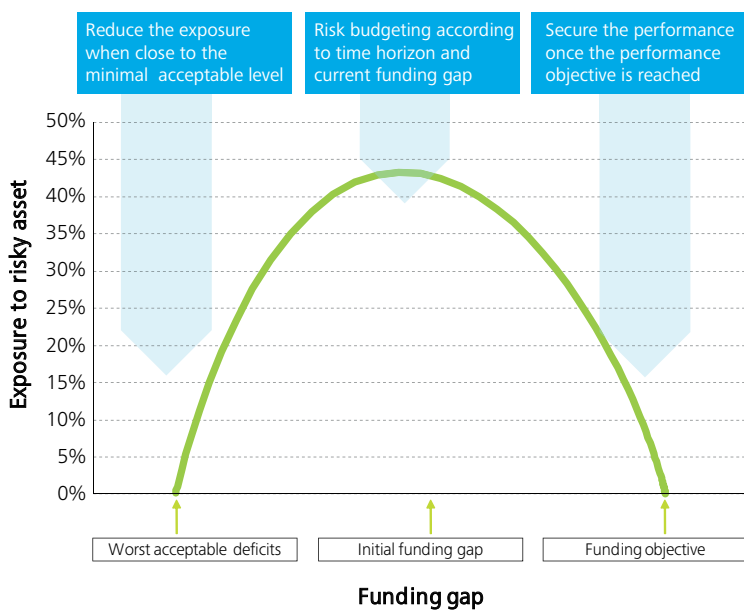


Figure 3: Optimal risk budgeting policy, depending on the funding gap





A break for overseas Chinese investment seekers?

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Before 2011, complying with the rules and regulations posted by the State Administration of Foreign Exchange (SAFE) probably was a job in itself for foreign investors seeking to enter the Chinese market as well as those who were already in China. SAFE is the gate keeper for any foreign currency flows into and outside of China and it therefore controls the funding for every single investment from outside China.

Right before the Chinese New Year, the Year of the Rabbit, a long-awaited new regulatory breakthrough for RMB funds was released by the Shanghai Municipal Financial Services Office. Officially dated 30 December 2010, the programme, named '*Implementation Measures on Pilot Program of Foreign-invested Equity Investment Enterprises in Shanghai*' (the 'Pilot Measures'), is a product of long and intensive coordination by the Shanghai Municipal Financial

Services Office with the Municipal Commission of Commerce, the Municipal Administration of Industry and Commerce and other key authorities such as the Shanghai State Administration of Foreign Exchange.

Shanghai is now the first city in the nation to create a unified authority to specialise in and handle emerging operational issues for RMB funds on this scale. This authority is called the *Joint Conference for Pilot Program*

of Equity Investment Foreign Invested Enterprises and includes all of the regulatory authorities necessary to facilitate the operations of RMB fund GPs, managers and funds in Shanghai. It is expected that this 'one-stop shopping' Joint Conference for RMB funds will rival the level of services and solution development available under all other RMB fund regimes currently in existence.

The Pilot Measures introduce implementation provisions for three types of RMB private equity fund entities: PE Manager FIEs, Equity-Investment FIEs, and Pilot Equity-Investment FIEs. Each entity may be established in the form of a partnership enterprise and the PE Manager FIE may also be established in the form of a company.

The PE Manager FIE represents a significant improvement over the existing rules for fund management vehicles in Shanghai because of an express ability to serve as the GP of a 'pure' RMB fund and invest in such a fund without changing the fund's nature with regard to foreign investment limitations. This means wholly foreign owned GPs are allowed to invest up to 5% in an onshore fund and this fund can invest in industries restricted from foreign investment as well as invest without approvals. The Equity-Investment FIE represents the first locally sanctioned RMB fund with foreign investment that sheds all of the restrictions imposed on so-called FIVCIEs with respect to scope of investment industry and approval procedures. The Pilot Equity-Investment FIEs go even further beyond this step but are only available to certain qualified sovereign wealth funds, pension funds, endowment funds, charitable funds, funds of funds (FOFs), insurance companies, banks, securities companies and other foreign institutional investors approved by the Joint Conference. Foreign exchange issues and deployment for investments by Pilot Equity-Investment FIEs are addressed in the context of a newly introduced custodian bank framework.

The Pilot Measures clarify related rules and regulations and mark an important milestone to attract foreign-invested RMB funds to Shanghai. The objectives of the Pilot Measure are: to promote the development of the PE/VIC sectors, in particular to attract experienced investment professionals to Shanghai, to create an effective framework to regulate the industry, to

encourage long-term equity investments by foreign investors and to monitor the quantum and directions of RMB investments.

The Pilot Measures allow a foreign-invested RMB fund and GP to be established in the form of a partnership. Various provisions set out the qualifications and set-up procedures with respect to the legal form, business scope and capital requirements of the entity. However, the following points should be noted:

1. The Municipal Financial Services Office of Shanghai is the responsible Bureau for the approval of set-up of foreign-invested RMB funds and GPs
2. The Municipal Commission of Commerce is responsible for approval of set-up of GPs in the form of incorporation, while the Municipal Administration for Industry and Commerce is responsible for set-up of GPs in the form of partnership
3. All capital contributions must be in cash. Foreign investors are allowed to invest with RMB generated in China
4. Minimum capital of USD 2 million is required for a GP, of which 20% must be in place within 3 months of receiving a business license and the remainder can be funded within two years
5. The foreign-invested RMB fund must use a qualified bank as the custodian to hold its funds

Since its announcement on 11 January 2011, DTT China professionals have been in active contact with the Joint Conference to understand further operation details and guidance. In our view, the Pilot Measure is a key step towards attracting foreign investors and creating a more level-playing field, even though the pilot programme might not necessarily address all the items currently on the wish-list of foreign investors—but it is a start!



Managing costs of global mobility programmes

by taking a strategic view of international assignments

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Global mobility—the international deployment of employees—is costly, but necessary, for competing in the global financial markets. In addition to providing executives with an experience that will enrich their professional development, international assignments enable organisations to put some of their high-quality talent in their most important markets

Asset managers have historically offered very generous compensation packages to their employees in order to entice the employees to go on international assignment. These packages have been deemed necessary to recruit and retain the best people.

However, in difficult economic times, many companies find themselves under intense pressure to reduce their global mobility costs. A single three-year international assignment for an employee making \$100,000 can represent an investment of more than \$1 million; moreover, mature global mobility programmes can amount to tens or hundreds of millions of dollars in supporting costs for a company.

Instead of simply reducing the number or duration of international assignments, asset managers can pursue greater value by taking a strategic view of global mobility that aligns their investment with the value of assignments while managing associated taxes, social security expenses and programme overhead costs.

Global mobility in uncertain times

No matter how long employers have been managing international assignments, some organisations still lack a clear understanding of their total investment in global mobility.

According to a recent informal online poll that Deloitte conducted among some 500 financial services executives, only 31% report that their investment in global mobility is accurately reported and actively managed. Another 40% say that their organisations can generate high-level estimates, while 29% admit that their companies do not have a clear view of their total global mobility investment.

Does your company have a clear view of its total investment in global mobility?

- Yes. This investment is accurately reported and actively managed: 31%
- Somewhat. We can generate high-level estimates: 40%
- No. We do not have a clear view of our total investment: 29%

"While international assignees typically represent as little as 1% to 5% of a company's employees, global mobility can represent as much as 5% to 10% of the company's investment in compensation and benefits" says Gardiner Hempel, partner and global mobility practice leader with Deloitte. "Even some very sophisticated companies may not have a good approach to align mobility decision making with business priorities. As companies better understand the value of global mobility, they have identified that as many as 25% to 50% of their mobile employees were not on the best kind of policy given the purpose of the assignment."

Taking a multidisciplinary view of global mobility programmes can help you assess costs and re-target mobility investments to where the value really lies. In some cases, asset managers can explore savings by concentrating on three cost levers:

- **Rebalancing the global mobility portfolio:** Companies can pursue potential savings of some 15% to 30% by adopting a value-based programme framework, managing assignment durations, managing home/host combinations, identifying and managing the value proposition and aligning policies with value and purpose
- **Managing taxes and social security:** Organisations can also pursue potential savings of 5% to 10% in their global mobility programmes by focusing on tax-effective pay delivery and social security expenditures
- **Reducing programme overhead:** In addition, potential savings of about 1% to 5% can be pursued by rationalising vendor relationships, streamlining operational processes and enhancing technology support

By addressing these areas of their global mobility programmes, employers can potentially impact their cost structures by some 21% to 45% over a period of two to three years.

Rebalancing global mobility portfolios

Many companies segment their global mobility programmes according to duration. Three common segments are long-term assignments, short-term assignments and permanent international transfers. The problem with this approach is that it treats international assignments equally and does not differentiate between low- and high-value assignments.

A value-based approach to global mobility, on the other hand, helps align a company's investment with the value of the assignment by: justifying the international transfer and business rationale; measuring candidate performance and potential; identifying candidate career path and succession; and discriminating between international transfer cost, objectives and duration.

How important is an international assignment experience for employees aspiring to senior leadership roles in your organisation?

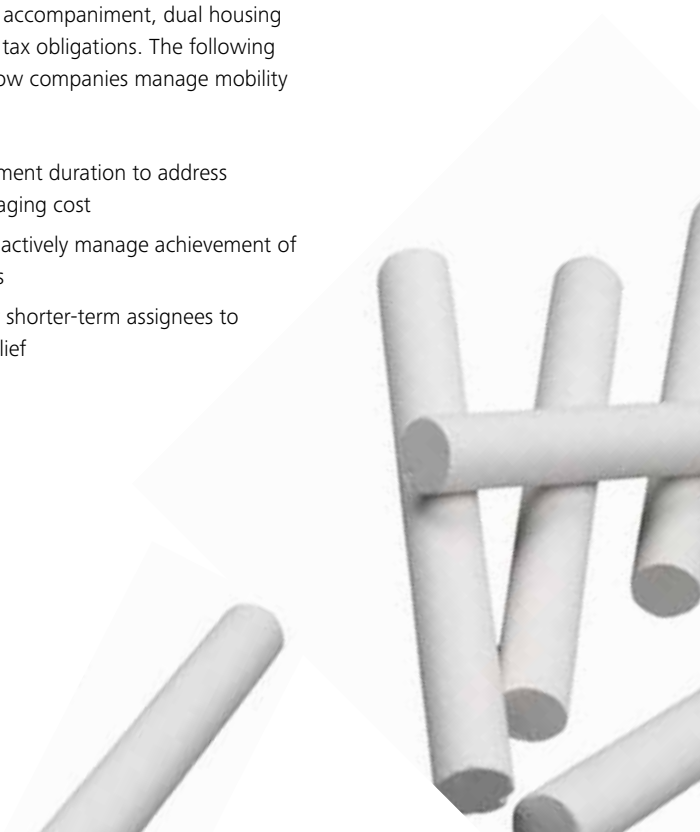
- **Extremely important.** In the future, most senior executives will have experience working internationally 21%
- **Important.** International experience will be an advantage for those aspiring to senior leadership 51%
- **Not important.** International experience will not be an advantage 28%

“An international assignment that combines high developmental value for the executive with high business value for the company offers greater rewards to the organization than an assignment that registers low on both scales” says Jonathan Pearce, partner with Deloitte’s global mobility practice.

To extract unnecessary costs from global mobility programmes, asset managers should consider taking the following steps:

Manage assignment duration. Assignment duration is a powerful driver of assignment cost, whose principal elements include family accompaniment, dual housing costs, and host country tax obligations. The following strategies can impact how companies manage mobility costs:

- Determine the assignment duration to address objectives while managing cost
- Develop processes to actively manage achievement of assignment objectives
- Monitor deadlines for shorter-term assignees to benefit from treaty relief



- Manage country-specific tax thresholds (for example, consider repatriating Japanese assignees prior to 1 January to avoid 15% inhabitants tax levy payable in June)
- Assess U.S. assignees on threshold of one-year to evaluate away-from-home expense rules, compared with exclusions
- Develop effective assignee repatriation process to monitor assignment end and manage timely repatriation
- Develop effective policies for localisation

Manage home/host combinations. International assignment location is a significant contributor to overall costs. While achieving assignment objectives is imperative, companies can also assist in managing the cost of deployment through exploring the portfolio of home/host combinations:

- Consider major versus growth markets
- Evaluate locations for costs arising from regional roles
- Review city and town locations for such factors as cost-of-living adjustments, housing and education
- Identify company tax and social security liabilities in host countries

Identify and improve the value proposition for employees. Articulating and improving the value proposition of mobility for employees enables rationalisation of financial support:

- Sometimes rich expatriate packages compensate employees for perceived career risks that can be mitigated at a lower cost through better talent management

- Incorporating global experience in leadership competencies and top-talent career plans help employees embrace assignments as valuable opportunities rather than hardships for which to be compensated
- In the face of increasing unemployment, some employees view mobility as an attractive alternative to the home marketplace
- Some nationals of fast-growing countries who are currently employed in developed markets are looking for opportunities to repatriate on a more permanent (low-cost) basis
- The greatest cost impact is likely achieved when there is alignment between the developmental/ career objectives of the individual and the immediate objectives of the business

Align policies with value and purpose. Aligning the right policies with the right kind of assignment may generate cost savings opportunities. For example, instead of maintaining 100 employees in traditional long-term expatriate assignments, it may be more cost-effective to have 50 of those employees in traditional expatriate assignments, 30 in short-term assignments, and 20 managing international functions or projects from the home market.

Whatever the mix of assignments, it is important to have a defined business case and approval process for international assignments. More than two-thirds of the executives that Deloitte surveyed in its recent online poll say that all (39%) or most (30%) international assignments have a defined business case and approval process. Only 30% report that their companies do not have such structures in place.

Does your company have a defined business case and approval process for international assignments?

- Yes. Each assignment is justified and approved: 39%
- Somewhat. Most international assignments receive the appropriate management oversight: 30%
- No. We do not have a clear consistent process for business case and approval: 31%

Managing taxes and social security

Asset managers can also manage the cost of their global mobility programmes by implementing tax-compliant protocols on compensation while taking advantage of possible tax relief.

One technique that is commonly used is changing the timing of payments. In some cases, it may be advantageous to prepay income before international assignments conclude; in others, it may make more sense to defer payment until employees arrive home.

Sometimes the nature of compensation can be converted from cash to other rewards. The compensation may be contingent upon completing an assignment or an employee's willingness to be mobile. The compensation may be sourced or not sourced as tax in the country of assignment, thus avoiding taxation. This also applies to gross-up costs associated with employer taxes that relate to that particular type of compensation or allowance.

Perquisites are another compensation area that may lend themselves to adjustment for tax purposes. Examples include housing, cost-of-living allowances and education benefits that companies typically provide to expatriates working abroad. If delivered in the right way, such perquisites can often be excluded from taxation.

It is also important to analyse pensions. When people who have worked abroad retire abroad, the first thing they look at are the tax treaties between the country of their assignment and the United States. In many cases, tax treaties will exempt pensions or other types of retirement pay from taxation in the country where the employees worked.

In addition, companies should never overlook social security because there are tax treaties among European countries and across many developed nations that, through proper techniques, will allow companies to avoid double taxation of social security tax.

One technique for reducing social security taxes is to establish a global employment company (GEC). While the value of utilising a GEC may not be fully quantifiable, it is possible to estimate the social security savings as in the following U.S. example:

U.S. outbound assignees: 700
Social security salary cap: \$106,800 (assumes all assignees meet or exceed cap)
Social security EE/ER contributions: 15.3%*
Social security tax on salary: \$16,340
Estimated benefit:
 $700 \times \$16,340 = \$11,438,000$ annually

For 2012 and beyond

Managing programme overhead

Asset managers may also find opportunities to lower the cost of their global mobility programmes by streamlining programme overhead. Operational cost-efficiency can be driven through process automation, process efficiency,



risk management via controls, and the appropriate alignment of talent to service delivery roles. These include:

- Moving transactional activities to a lower-cost outsourcer or shared service centre
- Implementing or enhancing technology to reduce manual labour costs
- Consolidating vendor support to realise economies of scale
- Reducing support levels and resources based on organisational drivers

Operational transactional costs for global mobility programmes are only about 5% to 10% at the high end, which potentially translates into an annual savings of 2% to 3%. This can be pursued by hiring global vendors to serve international assignments and gain economies of scale involving the management of taxes, immigration, relocations and other major activities.

Conclusion:

The whole is greater than the sum of its parts

Financial services executives recognise the benefits of adopting a value-based approach to global mobility.

According to Deloitte’s recent online poll, 57% of the executives surveyed believe their greatest opportunity for reducing costs lies in a combination of rebalancing their global mobility portfolio, managing taxes and social security and reducing programme overhead costs. Only 43% believe they are better off by implementing just one of these three approaches.

What do you believe your company’s greatest opportunities are for reducing costs in your company’s global mobility programme?

- Rebalancing the mobility portfolio: 12%
- Managing taxes and social security: 9%
- Reducing programme overhead costs: 22%
- All of the above: 57%

For more information about Deloitte’s approach to addressing the global mobility challenge, visit our website at www.deloitte.com/us/globalmobility





Selection and oversight of service providers to private fund advisers

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Introduction

Private fund advisers (for purposes of this article, a 'private fund adviser' is defined as an investment manager of a privately offered, pooled investment vehicle such as a hedge fund, private equity fund, collateralised debt obligation, real estate private equity fund, fund of hedge funds or fund of private equity funds) with limited infrastructure to support highly specialised and complex fund structures and investment portfolios may seek to outsource non-investment functions to service providers so that they can focus on the core competencies of generating investment returns, managing investment risk and raising capital. Leveraging third-party expertise may also enhance the cost structure, fundraising capabilities, control environment, scale and operational efficiency of a private fund adviser.

A private fund adviser may choose to engage a service provider to perform a wide range of activities, including fund administration, financial accounting and reporting, valuation, asset gathering, investor relations, corporate services, business continuity, technology support or application hosting, disaster recovery planning and tax and regulatory compliance services. Given the number and extent of business functions that can be outsourced, it is vital that a private fund adviser develop a robust framework for selecting and monitoring service providers.

An investment adviser's responsibilities (private fund or otherwise) are not minimised by choosing to outsource business and operational functions. Investment advisers

¹ The technical definition may vary from country to country. For example, in the United States, a 'private fund' is any issuer that would be an investment company as defined in section 3 of the Investment Company Act of 1940, as amended, but for sections 3(c)(1) or 3(c)(7) of that Act. A 'private fund adviser' is any investment adviser that is: (i) registered or required to register with the SEC (including any investment adviser that is also registered or required to register with the CFTC as a CPO or CTA) and (ii) advises one or more private funds.

who choose to delegate certain administrative and/or operational tasks still retain their fiduciary responsibilities for the delegated services and must therefore properly supervise the activities of its service providers. In the United States, under section 203(e)(6) of the Investment Advisers Act of 1940, investment advisers have a duty to supervise the activities of those who act on their behalf, including employees and other persons within their control. Investment advisers can have an affirmative defence to an allegation that a service provider has violated the federal securities laws if the adviser has created appropriate procedures and systems designed to reasonably detect and prevent violations of federal securities laws by service providers.

The adviser should select providers who are competent, have the capabilities and infrastructure to properly support the requirements of the investment adviser and have a well-controlled environment supported by a robust compliance programme to comply with the regulatory requirements governing the investment adviser. Investment advisers should also develop a process for reviewing and monitoring the services of the outsource provider so as to ensure their adherence to agreed-upon service level and established internal controls and procedures.

Selecting service providers

In selecting a service provider, it is important to develop a set of criteria that takes into consideration the types of outsourced services. A common mistake made by private fund advisers is simply documenting or setting baseline service requirements reflective of the current level of service provided by in-house staff or incumbent providers. Advisers should not apply another firm's business requirements, even if supplied by the provider, as a shortcut to fully developing a customised version for their own operating environment, but rather the adviser should develop a Service Level Agreement (SLA) that meets its unique needs and business requirements. Taking the time to identify and clearly describe the expected services and set minimum standards for accepted performance should pay dividends throughout the process.

The adviser should select providers who are competent, have the capabilities and infrastructure to properly support the requirements of the investment adviser, and have a well-controlled environment supported by a robust compliance programme to comply with the regulatory requirements governing the investment adviser.

In making a decision to outsource certain functions, the adviser should consider several factors:

- **Extent of services to be outsourced:** Clearly delineate functions that will remain in-house from those that will be outsourced. This will help to prevent duplication of efforts, weaknesses in controls or delays in the delivery of services or information resulting from confusion and inefficiencies
- **Policies and procedures:** Set clear policies and procedures that the adviser and service providers will be required to adhere to, including escalation hierarchy and guidelines for interaction with investors
- **Service standards:** Establish clear standards to measure performance and monitor the quality of services provided, including standards regarding the timing and quality of the delivery of services and information
- **Adviser's interaction with service provider:** Determine the desired level of interaction with service providers and assign internal responsibility for managing the service relationships. The ability or right of the adviser to review the service providers' processes through a site visit and/or use of a third-party consultant should be considered

- **Cost of outsourced services:** Analyse the internal cost of supporting the function that will be outsourced as a basis for considering the fees charged by service providers
- **Project assistance:** Determine how much time it will take to select a service provider, develop SLAs and undertake the transition. If the private fund adviser does not have the internal expertise to competently conduct the selection process, it may be necessary to seek the assistance of a third-party consultant to assist in the evaluation and selection of service providers

Evaluating potential service providers

The evaluation process is a crucial step in selecting the right service provider. In addition to conducting a careful review of the provider's reputation and business activities, the following key components should be evaluated in the selection process:

Fit or alignment of the provider

Possibly the most important factor in selecting a service provider may be how well a service provider aligns in profile and strategy with the adviser. It is important to find a provider who can handle the current state of the adviser's organisation and business objectives. If changes to an adviser's business are expected, it is best to prepare by ensuring that the service provider is equipped to adjust to these service changes. It is also important to understand how a provider services other firms with a similar business profile, investment strategy and operating model.

This review should go beyond a routine reference check as a provider may have an excellent reputation and a dominant position within the marketplace, but with clients that employ an operating model with very different business requirements and service standards. For example, where a private fund adviser invests in bank loans, it should determine that the administrator or accounting firm has the knowledge and infrastructure to support these instruments. To evaluate the provider's response, the adviser should seek supporting information, such as the number of other firms within their current client base who are trading in bank loans and the number of staff currently supporting those clients.

Another key consideration should be the service model of a given provider. While some advisers favour a single point of contact approach, others may prefer that the adviser have a specific contact for each function within the provider's offering. It may be matter of preference, but it is important to determine that an adviser's preferences match up to the provider's service model.

Breadth of the provider's service offering

The second key component within the evaluation process is the provider's ability to support the adviser's current operating model with the calibre of the provider's suite of service offerings. Where possible, an adviser should conduct a site visit to observe and understand the people, processes and technology in place that will service the adviser. When reviewing a provider's offering, identify and evaluate the core services paying particular attention to those services that are most important. If the provider performs a service that will directly impact investors (for example, tax preparation, capital account reporting, valuation, waterfall distributions/fee and expense allocations, and financial statement preparation), plan to assess their ability to meet these obligations. Do they have policies and procedures covering these functions? Do they have the technology to support complex processing? Can this be put into a SLA or contract?

Ability to adapt to potential regulatory or market changes

While it may be difficult to determine future business requirements, the adviser should evaluate the provider's ability to adapt to marketplace changes or challenges. Changes in the marketplace due to economic expansion, global recession, regulation, deregulation and tax law changes can occur and impact the financial services industry in general and a private fund adviser more specifically. A service provider should be flexible enough to adapt to change and have the resources to support its business effectively as market demands shift. An evaluation of the items listed below should help to determine the ability of a provider to perform capably during challenging times:



- Average tenure of staff and turnover ratios across the company
- Tenure of the staff working on the account
- Financial health of the organisation
- Technology employed, including hardware and software configurations or versions
- Disaster recovery and data management capabilities
- Sufficiency of policies and procedures content and administration
- Control environment
- Client turnover

Additional capabilities

Evaluating ancillary services may be just as important as evaluating the primary services to be provided. For example, the administrator's tax services may be used less frequently than accounting functions, but these services may be an important consideration for investors. Additionally, a prime broker's capital introduction services may be significantly more important for an emerging manager than a mature fund with a well established investor base to solicit investment into new products. The same principle would apply when selecting an auditing firm or legal counsel that offers regulatory consulting services (for example, how good is that service and who will manage it?). These services may not be high in cost or volume, but should be part of the evaluation process in the event that these additional services are needed.

Sound control structure

Where practical, the adviser should obtain the Type II SAS 70 reports (or similar reports under local standards) on their service provider's internal controls for an understanding of the control environment and certain compliance procedures. It should be noted that the AICPA is moving SAS 70 reports to a new attestation standard, SSAE 16; similarly, a new international standard was issued by the IAASB, under ISAE 3402. These new standards will be effective for service auditors' assurance reports covering periods ending on or after 15 June 2011. However, early adoption is acceptable.

Monitoring service providers

After selecting a service provider, commercial terms will be finalised, taking into account the specific services to be provided. An SLA either within the contract or a separate document is an effective tool for setting the ground rules of the relationship including escalation procedures for any problems. Having ground rules in places can reduce the uncertainty that can delay resolution of any issues that may arise.

**The evaluation process
is a crucial step in
selecting the right
service provider.**

Once the contract has been signed, an adviser can focus on managing the provider effectively and working to use their services to improve the adviser's business. Five key items to focus on when managing service provider relationships are:

Set appropriate expectations

This should be relatively easy if the private fund adviser has negotiated a SLA and established proper account management and escalation procedures. Over time, certain services can become less important, deadlines can wander or data quality can suffer. The adviser should set the ground rules up front with the service provider and be vigilant in their management. The adviser should be reasonable about what is needed, explain the needs clearly and build in compliance monitoring, including the right to audit or assess the service provider's operations as necessary. Setting reasonable expectations from the outset of the relationship can pay dividends going forward.

Assign an owner for the relationship

In many cases, a private fund adviser may have multiple points of contact with a service provider on a day-to-day basis and this may work very well during the usual day-to-day activities. However, when one-off items occur or problems arise, a central point of contact will help resolve the matter more readily and consistently than a fire drill or SWAT team-like approach to solving the problem.

A central point of contact at both the service provider and the adviser should enhance the relationship by designating someone who will invest time to get to know the provider, the people servicing the account, the provider's processes and, most importantly, how to navigate and communicate with the firm, particularly if problems arise.

Build a communication framework

Communication between the adviser and the service provider is clearly important. As stated previously, it is important to set the ground rules and assign an individual to own the relationship. The relationship may start smoothly with the parties communicating frequently through the data conversion, technology implementation, initial compliance review and audit preparation period. Once the intensity of the relationship subsides, communication frequently fades. This is why having an individual own the relationship is critical so that the owner will not let the communication falter or the framework defined at the outset become relaxed. Keeping the lines of communication open, even when relationships are going well, may seem unimportant, but a focus on new trends in the marketplace or business evolutions may enable the private fund adviser to identify issues proactively before they become a problem.

Define performance metrics and develop a measurement mechanism

It may be challenging depending on the type of service provider to define Key Performance Indicators (KPIs) for evaluating the overall services received and the quality of work performed. The parties should agree on the KPIs and acceptable success criteria, as well as define what constitutes below standard performance. Ideally, these conditions should be part of the discussions for contract or SLA terms. Building KPIs into the relationship with the provider and defining a regular monitoring process will go a long way to ensuring services continue to be delivered smoothly. As both firms incur turnover or people expand their roles within an organisation, establishing written KPIs will ensure consistency in the parties' understanding of performance expectations.

The relationship with a service provider begins with the setting of expectations, assigning ownership, building a communication framework and designing a plan for measuring and monitoring performance.

Work cooperatively with the provider

The relationship with a service provider begins with the setting of expectations, assigning ownership, building a communication framework and designing a plan for measuring and monitoring performance. The fifth and final element should exist throughout the selection, negotiation and ongoing relationship; in other words, the ability to work with the vendor. Collaborative and cooperative relationships will more likely ensure the vendors perform at a high level, especially as they learn more about the adviser's business and ultimately become more proficient at supporting the adviser's operations.

Conclusion

The process of selecting and managing a service provider can be challenging, but manageable if the private fund adviser follows the five key principles for evaluating a service provider: 1) ensuring the 'fit' or alignment of the adviser with the provider; 2) confirming that the breadth of their current service offering meets the manager's needs; 3) building confidence in their ability to adapt to potential changes; 4) understanding the additional services or value they are able to provide; and 5) ensuring that they have a robust control structure. Once the relationship is underway, following a few useful guidelines should help in developing a stable relationship with all of the private fund adviser's service providers and in monitoring them effectively. This stability can lead to a much more efficient business climate and an effective business model.



Compliance checks:

- Advisers who use service providers to handle certain administrative and/or operational tasks still retain their fiduciary responsibilities for the delegated services and must therefore properly supervise the activities of their service providers
- Advisers should undertake appropriate selection and monitoring processes

Appendix: Questions to consider when selecting service providers

Counsel (onshore and offshore)

- Is the counsel responsive in handling inquiries relating to both onshore and offshore issues?
- Do they have the necessary regulatory expertise for your business?
- Are they servicing too a few clients to be up to date on market practices?

Prime broker

- Is a multi-prime or single prime model most efficient for your firm?
- If using multiple prime brokers, should you consider an introducing or mini-prime to gain exposure and utilise some of their technology and reporting services?
- Are you confident in the stability and balance sheet of the counterparty? Will using this prime broker cause concern with your investor base?
- Does the prime broker have access to the financing you need and capacity to support any securities lending/borrowing requirements you have currently or may have in the future?
- What other services besides trade execution and clearing are important to you (e.g. cap into, trading strategies, market research, technology support, reporting or consulting services)?
- Can they support your current and future trading needs from both an asset class and a geographic perspective?

Auditor

- Is your current auditor available throughout the year for ongoing support?
- Are they as knowledgeable on your market segment as when you hired them?
- Who is your lead client service partner? Is he/she accessible?
- Will potential investors recognise the auditors?
- Will you outgrow or have you outgrown your auditing firm?

Tax adviser

- Does your tax adviser understand your business and your risk tolerance?
- Do they proactively reach out to discuss current developments and structures?
- Do they explain technical issues in plain English?
- Are your K1s and tax returns delivered on a timely basis in order to allow appropriate internal review before issuance?
- Do you have access to the appropriate level tax talent when you need it?

Placement agent or third-party marketer

- Has their support been steady throughout the relationship? Or has their support diminished over the years?
- Are there any potential conflicts of interest that would diminish their service to you?
- Do you have any upcoming marketing or sales needs that require specific support?
- Are they a registered investment adviser and/or broker dealer (in the United States)?

Outsourced compliance testing and chief compliance officer services

- How knowledgeable is the staff at your current provider? Are they proficient on private fund regulatory topics? Should you seek a more experienced provider?
- How does the provider remain current on regulatory developments and does it participate in relevant professional groups?
- What proactive compliance services are you getting currently? Is this enough or would you appreciate more routine testing and communications with the provider?
- Do they leverage technology to 'operationalise' ongoing services if outsourced?

Valuation specialist

- Are you comfortable with their modelling and analysis?
- Are there any third-party metrics or comparative analysis they do to their valuations to test the valuations provided?

Market and security level data providers

- What substantiates the data that they are providing (e.g. where are they sourcing data? If models are used, who reviews the models, do they revalue or reprice?)
- What is the process for updating prices should new information become available?
- What is their market share?

Software and technology providers

- For software, what reports exist currently within the product? How much customisation would be necessary to support your business now and in the future?
- Can the software support waterfall calculations for private equity partnerships? What amount of pre-processing or setup will be required to do so?
- What prepackaged internal and external reporting do they have? Will they be able to integrate with external printing applications if necessary?
- What is the disaster recovery process for the software?
- What is the time frame for implementation and at what cost?

Fund administrator

- What level of experience do you want the administrator to have with your private funds (e.g. private equity, hedge funds) business? Is it necessary that they be able to handle other fund types, for example collateralised loan obligations?

- What other services will they provide? Tax? Is investor reporting included, or at an additional cost?
- Are they supporting funds with the same strategy? How many? What will be the tenure of the staff assigned to your portfolios?
- What account management and escalation procedures do they have in place?
- Will they make time commitments deadlines for delivery of information?
- What periodic exception reports do they typically provide? Can you customise the type and frequency of exception reports?
- What is their valuation policy including fair value process for illiquid securities?
- How are errors handled?





Investment management

Risk rewards

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Managing tax effectively is an important factor in the ongoing success of an investment manager's relationships with investors, regulators, shareholders, employees and other stakeholders. With recent and expected changes in the economic, legislative and regulatory landscape it is increasingly important that investment managers focus on developing a clear tax strategy which encompasses both the tax affairs of the group and the products they develop with a view to generating sustainable value through tax and avoiding unpleasant surprises. Central to this is to ensure that the strategy is supported by a robust framework for the management of tax risk and that the framework is fully integrated in the rest of the business.

Whilst in the past the tax function may have been seen as somewhat remote, at best a distant part of the finance function staffed by technical boffins representing another cost centre, the tax director of today realises that being a partner to the business is vital in order to give a comprehensive snapshot of the tax risks the

business faces. It is not surprising within an investment management group that as little as 20% of the tax risk arises within the tax function with 80% arising within the wider business. So whilst, for example, getting transfer pricing wrong can have material financial effects, publicity and reputational issues around product risk (e.g. trading on segregated accounts, losing UK or German tax status) could bankrupt even the biggest firms.

What is a tax strategy?

A tax strategy usually comprises goals around the themes of:

- Minimisation of tax costs on a sustainable basis, including targets for cash tax outflow (corporate taxes, securities taxes, irrecoverable indirect taxes, etc.) and costs of compliance
- Compliance with applicable laws and regulations which might include targets for filings, payments and, potentially, tax authority risk ratings

- Greater certainty in tax reporting giving potential targets for ETR and management of information provided to investor and analyst communities around key tax items

Within an investment management group, those goals will not only relate to the corporate group itself but also the structural and transactional risk associated with the funds and investment management mandates that the group operates. The institutional market, in particular, is waking up to the tax inefficiency of products—for example, pension funds investing in U.S. equities via opaque pooled funds. Similarly, the retail distribution review may lead to an increased focus on tax efficiencies of investments. Risks around selling tax inefficient products may change significantly.

Why develop a tax strategy?

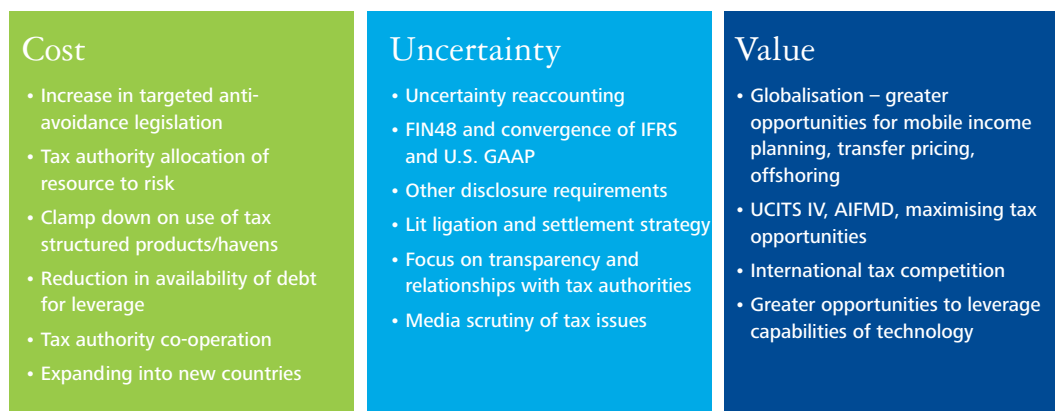
Many organisations have an informal tax strategy which, in reality, is more of a shared understanding among the finance and tax leadership of broad aims. Typically this is neither documented, explicitly agreed by the board nor communicated widely. Historically this has not been an issue as tax was not regarded as a sufficiently significant source of cost, uncertainty or value to the organisation to merit this level of consideration.

Changes in the economic, regulatory and wider landscape mean that this is no longer the case (see figure 1).

Tax and tax compliance is increasing as a cost as tax authorities seek to do more with less, focusing resources on the higher risk taxpayers, increasing expectations of self-review for the rest and looking to financial institutions to help them achieve that. The UK, Germany, Austria and Switzerland all now have detailed but different investor tax reporting regimes which need to be complied with if investment managers are going to attract investment. The EU Savings Directive imposes certain withholding tax or exchange of information obligations on certain funds and investors, and most recently the US has introduced complex and extensive reporting and withholding tax obligations on funds with US investments. These provisions are referred to as the 'Foreign Account Tax Compliance Act' (FATCA) and apply from 1 January 2013.

Uncertainty is increasing as legislative complexity increases, accounting standards change, tax authority settlement strategies become less flexible and transparency over areas of tax judgement (e.g. uncertain tax positions) increases. FIN 48 'Accounting for Uncertainty in Income Taxes' requires all funds which report under U.S. GAAP to identify, recognise and ultimately measure certain uncertain tax positions. This will include the decision whether or not to file a tax return in another jurisdiction and will require consideration of the specific tax risks which can arise at various points within the investment process. Tax residence of the fund, 'permanent establishment' risk and tax liabilities on investment returns either by way

Figure 1: Drivers of increased potential cost, value and uncertainty relating to taxes



of withholding taxes or by assessment are all risks that will need to be considered. Fund boards that may not be subject to FIN 48 are adopting similar thinking to the management of their wider tax governance responsibilities.

At the same time, the value achievable through effective management of tax has never been higher or more visible. UCITS IV, the AIFMD and the Dodd-Frank Act are all external drivers that are requiring businesses to step back and reflect on the way they structure their business. More generally, globalisation is making it ever easier for businesses to move management, intellectual property, risks and functions to lower tax jurisdictions.

In this new environment, finance directors and heads of tax should be looking to develop and agree tax strategies which they can communicate to everyone involved in the management of taxes so as to ensure that their actions are appropriately directed toward group goals. Getting this right will require everyone in the business—from product development to IT, from individual investment managers to distribution and marketing, and HR—to look at their area and whether it is either tax efficient or a tax risk and look to the tax director and his team for direction and support.

Developing your tax strategy

What then are the steps that should be taken by a head of tax in developing a tax strategy? Of course, this will be hugely dependent on the specific focus of the business, its asset focus, its client focus and its tax profile but we usually see the following general steps forming part of their plan:

- **Reassess risks and opportunities:** Sit down with the key individuals within the group which could include the finance director, chief risk officer, chief investment officer, head of product development, head of operational risk and head of internal audit to identify, analyse and agree existing tax risks and opportunities and how they are currently managed and communicated. Determine how the specific tax risks could be triggered in the investment management and recommend new improved controls to manage these risks, specifying how and when they should be applied within the existing process and control framework. Establish agreed framework for evaluating risk and future tax-planning opportunities
- **Find out where the value is:** Monitor the company's current initiatives and strategic priorities with a view to aligning tax strategy and activities. Develop tax strategy including identification of one or two 'quick wins' to help build credibility. Within investment management groups, this is likely to be around maximising opportunities arising from transfer pricing, reviewing the VAT classification of the various delegated functions and considering the outsourcing of activities. Does it make sense that the in-house tax function is focused on corporate tax returns, fund tax returns, fund investor tax reporting and indirect tax reporting or can greater efficiencies be achieved through outsourcing these activities, leaving the tax department to focus on higher value and potentially riskier tax issues?
- **Build bridges to the business:** Make tax and its role in value creation easier for the wider business to understand. Create business cases for tax activity. It is particularly important that the front office recognise that there may be significant tax consequences associated, for example, with stock lending in a particular jurisdiction. Without appropriate planning it may result in a tax exposure or at the very least a tax filing obligation. Tax representation within the product development



committee or investment approval process is vital in this regard

outcomes of delivery against updated strategy and risk analysis

- Make the case for the importance of tax:** Prepare a plan for specific actions based on a standard framework for planning evaluation which reflects agreed appetite for risk, etc. Many investment management groups have established working groups to understand the opportunities and challenges associated with UCITS IV, the AIFMD and RDR but not all have ensured tax is appropriately represented. The former provide real opportunities to embed tax efficiencies at the first stage of corporate planning. The latter requires careful planning to ensure that the tax costs associated with providing advice are not doubled overnight. All parts of the business need to understand their role in the success of the plan, namely ensuring tax is involved at the earliest opportunity and the potential downside of failure to do so
- Deliver:** Once your plan is in place, make sure you have the right type and balance of resources. It is quite likely that the skill set and focus of those directly involved within the tax function will change and greater focus will be placed on having systems and processes in place to monitor those with direct oversight of tax risk within the business units. It is the important to track delivery against expected risks and monitor how these are managed and assess

Developing your risk management framework

In managing the strategy it is important that a framework of resources, policies and systems is put in place that supports how tax risk should be managed within an organisation and by whom. We see three main layers:

- 'Tone from the top':** A clear statement of policy around the strategic direction, parameters for action and clarity over roles and responsibilities and segregation of duties in respect to the management of taxes across the organisation. It is important that individual investment managers recognise that tax risk is a key part of any investment decision
- Tax activities:** The processes, procedures and tools for managing tax risk within key tax activities (e.g. planning, compliance, investment process, investor reporting, tax authority enquiries, etc.) across divisions and jurisdictions
- Tax operations:** The people, data, systems, knowledge and tools which support the above activities. Detailed roles and responsibilities will need to be documented and management of tax risk embedded into performance review/rewards of those involved



Where possible, new or improved controls should be aligned with and build on existing processes and controls for the management of risk. Questions then need to be asked about who should be responsible for the effective operation of controls over tax risk—should it be embedded within the existing business operations or should they sit with the tax department? Establish clearly the role of the tax function—is it a general oversight role or is it to provide specialist support to the business units as they design and implement the controls and then one of monitoring and assurance?

Tax activities

Each tax activity will have specific policies, procedures, methodologies and tools which control relevant tax risks. For example:

- For **planning**, a key objective would be that uncertainties relating to fund structuring and investment transactions are managed such that the anticipated result is likely to be secured. The specific controls that would look to achieve that could include: policies governing and tools enabling selection, design, implementation, maintenance and defence of transactions
- For **indirect tax compliance**, a key objective would be to ensure the integrity and accuracy of the relevant VAT processes and systems. Relevant controls would then include: defined procedures for gathering, analysing and reporting data for VAT return purposes as well as maintenance of customer and other master data which may impact on VAT determination
- For **tax authority investor reporting**, a key objective would be to ensure that tax data and other information requested by the authorities are provided in a complete, timely and controlled manner. To this end, controls may include protocols setting out how documentation should be retained, stored, reviewed and provided to tax authorities with such matters embedded within service level agreements where relevant. Particularly important is agreeing who is carrying the tax risk given that errors are likely to result in individual investors having to refile returns

Tax operations

Informed by the tone from the top, the 'tax operations' are the people, processes and systems through which the tax activities are delivered. Establishing this infrastructure in an appropriate way is critical in enabling the tax strategy to be delivered and the associated risk effectively managed. Considerations at this level of the framework would include:

- **Organisation:** centralisation vs. decentralisation of tax resources; use of shared service centres; near/off-shoring; outsourcing to administrators, custodians or professional advisers
- **People:** requirements (skills, experience, qualifications); recruitment; performance management and incentivisation; development and training. It may well be the case that the skills required are somewhat different from those in the past. Analytical and project management skills are increasingly important
- **Information and data:** knowledge management especially in the context of the typical 'outsourced' model of administrators, custodians, transfer agents, etc.; tax data warehouses; intranet and portals; XBRL and e-filing
- **Process and systems:** set-up and maintenance of ERP and accounting systems; use of bolt-on technologies (e.g. for tax reporting, financial statements); tax return technologies; workflow systems

The final element of the infrastructure is risk control itself. Part of risk control involves reviewing the existence and effectiveness of the controls that make up the overall framework, identifying gaps and issues and ensuring that there is appropriate follow-up. A further part is the process that enables the organisation to identify, evaluate, manage and report new tax risks and ensure they are incorporated into the framework on an ongoing basis. Such reviews and processes can be carried out through self-assessment, internal or external exercises. Regardless of who carries out the review, the key is that the risks identified are owned and actively managed with regular update reports.

Balancing value and risk

The developing economic, legislative and regulatory environment presents significant tax challenges to investment management businesses. How they manage tax risk can affect both their financial performance and reputation with dramatic results.

Leading organisations are ensuring that they have a clear strategy to manage the threats and opportunities that these challenges present, aligning this with their wider corporate goals and go-to market strategy and ensuring that importantly they have buy-in from the board and the rest of the business. These organisations recognise that strategic decisions need to be taken about the role of the tax function, the kind of skill sets it requires and how it interacts with the rest of the business. It can no longer say it is different from the rest of the organisation and immune to the increasing focus on cost reduction and risk management. These companies are developing control frameworks which position them better to control tax-related activity wherever it occurs and identify and address risks as they arise. Businesses that can get the balance of strategy and risk right will have a competitive advantage over their peers as they are able to consistently deliver value through the effective management of their taxes.

Where possible, new or improved controls should be aligned with and build on existing processes and controls for the management of risk.





New tax regulation for investment funds in Germany

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As far as investment funds are concerned, there have been and will be significant changes to German taxation rules, namely (i) the Annual Tax Act 2010 and (ii) the German UCITS IV Implementation Act.

Whereas the Annual Tax Act 2010 had already passed the legislative procedure and broadly entered into force on 14 December 2010, so far the draft bill of the German UCITS IV Implementation Act has only passed the Lower House of Parliament and is not expected to be published and thus enter into force before June 2011.

The Annual Tax Act 2010 comprises regulations (i) fine-tuning the tax assessment provisions applicable to the 2010 assessment period at the time of the Annual Tax Act 2010 coming into force as well as correcting clerical errors of previous tax legislation and (ii) preparing amendments for future tax assessment periods. The provisions concerning taxation in the UCITS IV

Implementation Act mainly relate to the deduction of withholding tax on dividends and investment income.

This article solely focuses on the amendments to the German Investment Tax Act (InvStG) regulations and the fiscal consequences for (i) the taxation of investment fund units held by German investors, in particular alterations of the bases of taxation, tax figures and publication obligations of funds or administrators, and (ii) the changes regarding the deduction of withholding tax on dividends and investment income.

Bases of taxation, § 5 InvStG

In order for an investment fund to be treated as a transparent fund and therefore benefit from the advantageous funds taxation regime, it must publish the bases of taxation in the German Electronic Federal Gazette (*eBundesanzeiger*) in accordance with the publication scheme stipulated in § 5 InvStG, together with a 'professional tax certificate' (*Berufsträgerbescheinigung*), on a yearly basis. For the purpose of making the scheme more suitable for business practice by deleting non-tax-related information and adding information which in most cases had already voluntarily been published previously, this scheme has been rewritten and rearranged by the Annual Tax Act 2010 as follows:

- In order to ensure that the tax-related data may be (i) easily traced in the *eBundesanzeiger* and (ii) unequivocally allocated to the relevant tax assessment period, the International Securities Identification Number (ISIN) and the respective tax assessment period have been added to the publication data
 - The deemed distributed income (*ausschüttungs-gleiche Erträge*) from previous years must no longer be published on a year-by-year basis. Rather, only the aggregate amount of deemed distributed income from previous years must be published. However, the amounts of substance distributions (*Substanzausschüttung*) have been added to the information to be published
 - The earning components of the distributed revenues have been reclassified
 - Whereas under the old legislation only the aggregate amount of the parts of the distributed revenues subject to withholding tax had to be shown, their breakdown between domestic dividend-related amounts and amounts relating to other income must now be published
 - Creditable and refundable withholding tax on capital (*Kapitalertragsteuer*) amounts no longer have to be published, as withholding tax credits/refunds could not be claimed based on the published information
 - Creditable and deductible foreign withholding tax amounts are now to be shown separately (i.e. gross) whereas under the old legislation the stripped-down investor-specific (net) values were published
- The difference between the withholding tax paid in a specific fiscal year and the withholding tax refunded in the same or a previous fiscal year must be published
 - The amount of non-deductible income-related expenses must be shown. However, this does not have any practical impact on the fund industry as it is already common practice

Essentially, the new publication scheme must be observed and applied for fiscal years beginning after 31 December 2010. However, the Federal Ministry of Finance (BMF) has issued a circular dated 10 February 2011 based on which no negative tax consequences will occur if the new publication scheme is only applied to distributions taking place after 30 June 2011. As a consequence, during an ongoing fiscal year that began after 31 December 2010, an investment fund could still use the old publication scheme for distributions occurring up to 30 June 2011 but must switch to the new publication scheme for distributions occurring subsequent thereto.

The professional tax certificate must indicate the data to be shown include income equalisation (*Ertragsausgleich*)—for more details see the relevant paragraph below—irrespective of whether such income equalisation was carried out at fund accounting level or for tax purposes only. Publication of this information is essential towards the fiscal recognition of an interim profit (*Zwischengewinn*). According to the new legislation, (i) upon a purchase, an interim profit will only be considered as negative income, and (ii) upon a sale, the interim profit taxation principles only apply in favour of an investor if the fund performs income equalisation. Otherwise, in scenario (i) above, the interim profit is not recognised at all, and in scenario (ii) above, the fund is subject to a 6% penalty tax on the redemption or sale price without the possibility of offsetting the paid negative interim profit. Whereas the preamble of the Annual Tax Act 2010 states that this regulation simply declares what was already applicable and held by the tax authorities before (see the BMF Circular of 18 August 2009), the significant voices in the technical literature are of a different opinion. In any case, to some extent this clarification has to be welcomed by the fund industry because it gives legal certainty. Notwithstanding this, based on the Circular of 11 February 2011, the 6%

penalty tax shall not apply in the event that there is no indication as to whether or not income equalisation has been considered for the calculation of an interim profit (*Zwischengewinn*) with respect to publications occurring on or prior to 30 June 2011.

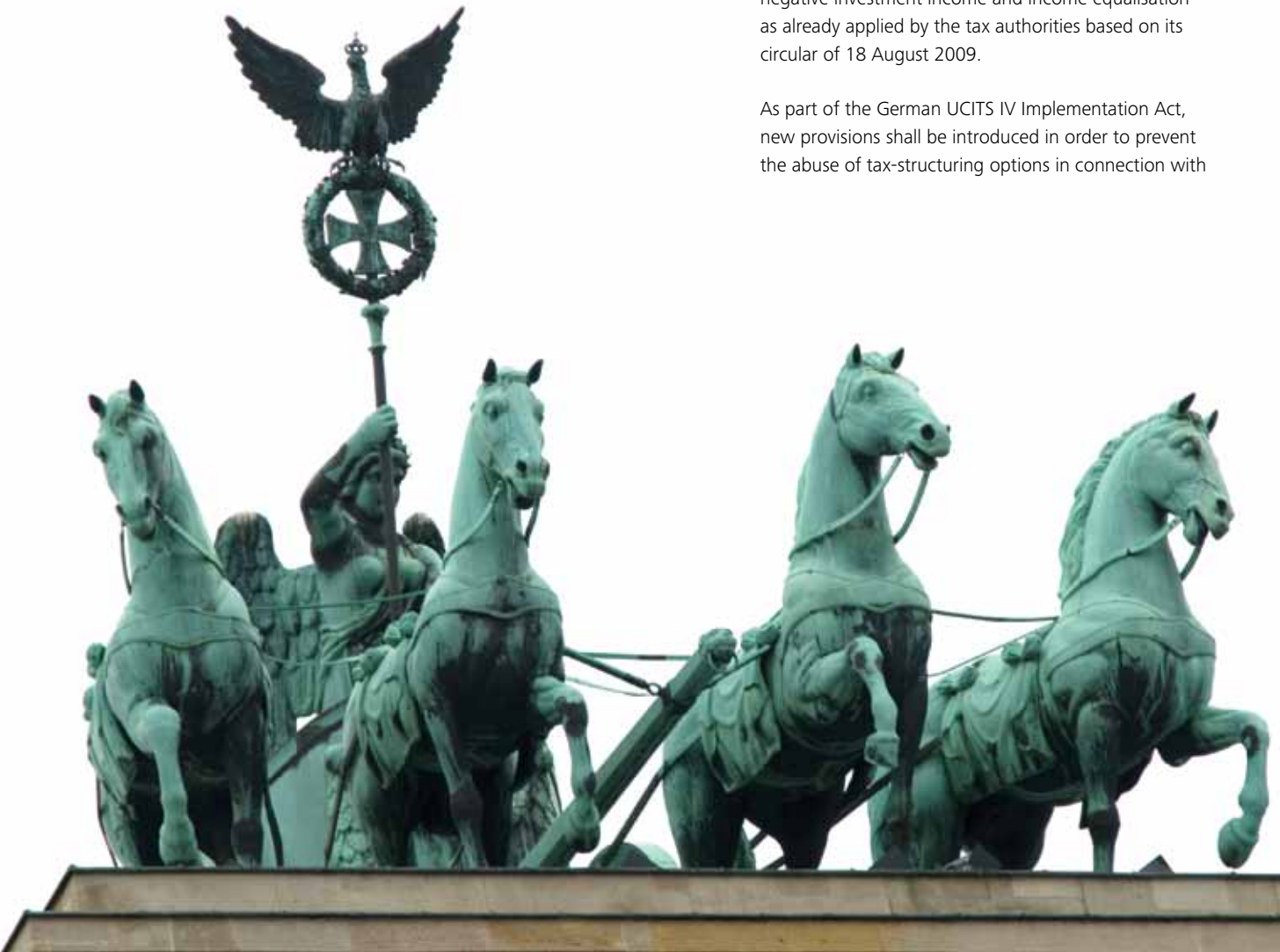
Furthermore, under the new legislation, potential income tax benefits on dividend income (i.e. application of the partial income regime for individual business investors and the 95% exemption for corporate investors) shall only be granted to business investors if the investment company calculates and publishes the equity gain (*Aktiengewinn*) every day on which the respective fund or administrator publishes its NAV. Consequently, German business investors will be taxed unfavourably (i.e. on a full capital gains basis) if they invest in investment funds that do not publish their equity gain in the aforementioned manner. This

change in taxation is due to the fact that it has been common business practice for investors to collect tax-free distributions or deemed distributed income and deduct an alleged loss from selling fund units. These new taxation principles take retroactive effect as of 20 July 2010 (beginning of publication of equity gain) as investment funds only had the possibility to opt for publishing the equity gain within two months of the publication of the initial draft bill (*Referentenentwurf*) of the Annual Tax Act 2010. However, efforts are being made to convince the tax authorities to reopen the (already expired) option possibilities.

Earnings from investment units, § 2 InvStG

The first change is the introduction of the restriction on the recognition of negative investment income from interim profit (*negativer Einkaufszwischengewinn*), as already outlined above. The new provision stipulates by law the accessoriness between the recognition of negative investment income and income equalisation as already applied by the tax authorities based on its circular of 18 August 2009.

As part of the German UCITS IV Implementation Act, new provisions shall be introduced in order to prevent the abuse of tax-structuring options in connection with



cum-/ex-trades of shares (*Leerverkäufe von Anteilen*), the redemption of shares and deemed distributed income (*ausschüttungsgleiche Erträge*). In the past, such structuring options were used to achieve unjustified withholding tax advantages (i.e. by means of doubled withholding tax credits). In order to achieve said goal, the withholding tax deduction obligation shall be transferred to the paying agent (*Zahlstelle*; for more details please see withholding tax paragraph below). In detail, the new provisions envisage covering three kinds of fact pattern, namely (i) (partially) distributing German and foreign investment asset pools with a high distribution ratio, (ii) German accumulating investment asset pools including pools with a low distribution ratio and (iii) the redemption of investment units on/about the accumulation date (*Leerrückgaben*). In scenario (i), any compensation payment derived shall be treated as a distribution; in scenario (ii), any withholding tax amounts would qualify as receipt of compensation payment equivalent income. Both kinds of income/payments are to be included in the disclosures as per the German publication scheme.

As per the transition rules of the law, the new provisions shall only be applicable with respect to capital income (deemed to be) distributed after 31 December 2011.

Foreign income, § 4 InvStG

The changes in the foreign income provision are mostly of a clarifying nature only or are intended to smooth systematic issues caused by amendments to other provisions.

The reference to the progressivity retention (*Progressionsvorbehalt*) in § 32b of the German Income Tax Act (EStG) is ultimately only of relevance for foreign real estate income derived by German private investors from third countries outside the EU/EEA. Income from countries inside the EU/EEA is no longer subject to the progressivity retention due to previous changes to § 32d EStG. The purpose of the amendment is to grant equal tax treatment to an investment through investment funds as is granted to a direct investment for these German investors. As a result private investors fall under the German flat rate tax regime (*Abgeltungsteuer*) and

corporate and business investors may be privileged with their income resulting in no or low taxation.

German withholding tax, § 7 InvStG

The obligation for domestic investment funds to retain withholding tax on capital which previously applied to domestic dividend income—for contemplated changes please see below—has been extended to income from German-situated real estate/property, to the extent that Germany has an unlimited right to tax such income based on applicable international tax law (in particular applicable double taxation treaties). The amendment shall particularly improve/assure the levy on investors only subject to limited taxation in Germany (i.e. with their German sourced income).

Furthermore, a provision has been introduced entitling corporate and business investors subject to unlimited taxation in Germany (*unbeschränkt steuerpflichtig*) to opt for an abandonment of withholding tax on capital deduction at source on certain kinds of investment income (e.g. foreign dividends and similar, option writer premiums, realised gains on futures and forwards and capital gains from transfer), if such income qualifies as business income. This change in law shall ensure a corresponding tax treatment with direct investors and is merely a confirmation of the opinion stated by the Federal Ministry of Finance in its circular of 18 August 2009. It involves a more detailed publication obligation with respect to the bases of taxation, which was already common business practice in the fund industry.

The reimbursement procedure for withholding tax on capital retained has been simplified. Accordingly, a domestic custodian retail bank may apply for a refund with its local tax office so that the reimbursement procedure between the domestic custodian retail bank and the domestic investment company may be avoided. However, where units owned by a non-German investor are kept in a non-German deposit, no domestic paying agent (*inländische Zahlstelle*) is involved. As a consequence, the reimbursement continues to be made by the domestic investment company on behalf of the non-German paying agent. This applies accordingly to non-German tax exempt investors who are comparable

to domestic pension funds (*Pensionskasse*) and request the reimbursement of withholding taxes on income from domestic real-estate investment asset pools.

Based on current law, (i) in the case of distribution/reinvestment with respect to dividend income and income from German-situated real estate/property and (ii) in the case of reinvestment with respect to other income, the withholding tax deduction obligation is imposed on the German investment company. Even under current law, the withholding tax deduction is the obligation of the paying agent only in the case of distribution of other income. As a further consequence of avoiding any tax leakage due to the abovementioned tax structuring options, the German UCITS IV Implementation Act shall introduce a revision of the deduction obligations regarding withholding tax on capital (*Kapitalertragsteuer*) for the German investor at fund level such that, going forward, withholding tax deduction—as applicable—is the obligation of the domestic paying agent (*inländische Zahlstelle*), the domestic custodian bank (*Depotbank*) administering/keeping the investment asset pool or, in the case of disbursement of investment income to a foreign agent, the central securities depository committed with the collective deposit ('withholding tax obligor'). This means that the German legislator envisages abandoning the debtor principle (*Schuldnerprinzip*) in favour of a paying agent principle (*Zahlstellenprinzip*) for investment funds. Insofar as the amounts available at the withholding tax obligor are not sufficient to cover the withholding tax amounts (including any auxiliary withholdings thereto), the investment asset pool has to make available such additional funds as are needed to cover the withholding tax deduction obligations. As far as withholding tax refund in 2011 (i.e. prior to the new provisions becoming applicable) is concerned, such refund will only be accepted in the hands of the investment asset pool if it is the legal owner of shares at the time of the resolution on the distribution of profits. Notwithstanding the above, it should be noted that non-German reinvesting investment funds should not be affected by the contemplated changes in law but income derived from such funds continues to be declared and taxed in

application of the standard tax assessment procedure (*Veranlagungsverfahren*).

Disposal of investment units; decline in value, § 8 InvStG

Under the new legislation, the gain from the disposal or redemption of an investment unit is to be increased by any substance distributed during the German investor's period of possession. The same applies to distributions of an allegedly tax-free liquidity surplus caused by depreciation and depletion. The legislator states in the preamble that this change in law is merely a clarification and therefore postulates a retroactive effect.

However, once again this view is not shared by significant voices of the technical literature.

Based on a newly introduced provision, investment asset pools may be regarded as a tax deferral scheme if the prerequisites stipulated in § 15b EStG are fulfilled. Accordingly, losses generated by such a tax deferral scheme can only be offset against future income of the same income source which, in the cases under discussion in this connection, matter of factly leads to a definite non-deductibility of such losses.

Income equalisation, § 9 InvStG

A new sentence has been introduced stipulating that an income equalisation must also be carried out with respect to interim profits such that in case of an income equalisation, interim profits are to be increased by the corresponding portions of the issue price of issued unit certificates. The application of income equalisation shall ensure that the income per issued unit certificate is not influenced by the issue or redemption of unit certificates.

In accordance with significant voices of the technical literature, the conjunction between the accomplishment of an income equalisation and interim profits is generally incomprehensible, as under the application of the German flat tax regime interim profits have to be excluded from the capital gain computation, thus solely resulting in a shift between current profits and capital gains. However, since the method of calculating



income equalisation is a German characteristic and is not adopted in most other countries, German investors in foreign investment funds that do not accomplish income equalisation using the German method may not recognise interim profits as negative income. Even though, in principle, this is merely a time-related disadvantage for most investors, this change in law may actually result in structural disadvantages for foreign investment funds aside from considerable time and effort for funds (whether they are German or foreign funds accomplishing income equalisation), administrators, custodian banks and certified professionals.

Merger of Funds, §§ 14, 17a InvStG

The amendments in §§ 14 and 17a InvStG mainly relate to adjustments regarding two specific types of mergers, namely the simultaneous transfer and assignment of all assets of one fund to several funds and vice versa. Under the old legislation, deemed distributed earnings of the last financial year of the transferor fund not distributed at the transfer date were already deemed to have accrued to the unit holders of the transferor fund at the end of the transfer date. Pursuant to the supplement in the new legislation, the accrual fiction is expanded on all other current income accrued at the transferor fund which are not per se part of the deemed distributed earnings.

Foreign special investment funds, § 16 InvStG

The cancellation of negative carried forward earnings to the extent an investor disposes of or redeems investment units held, which was previously only applicable to German special investment funds, has been extended to foreign special investment funds.

Furthermore, the law has been amended so as to improve the tax registration of foreign special investment funds with the Federal Central Tax Office (*Bundeszentralamt für Steuern, BZSt*) in such a way that a non-German special investment fund has to present a professional tax certificate indicating whether its tax figures have been determined in compliance with German tax rules if there is at least one German investor.

Conclusion and perspective

Annual Tax Act 2010

The amendments to the existing taxation rules for investment funds introduced into the Annual Tax Act 2010 comprise regulations fine-tuning the tax assessment provisions applicable to the assessment periods from 2010 onward as well as correcting clerical errors in previous tax legislation and preparing amendments for future tax assessment periods.

To a substantial extent, the changes of/amendments to the InvStG are an adaptation of the law to common business practice, in particular the revision of the bases of fund taxation.

A further material part is the introduction of previous tax approaches of the German fiscal authorities into the InvStG which, according to the legislator, are only declaratory but which in fact, and according to the technical literature, are an actual change in legal provisions. This applies in particular to some (virtual retroactive) alterations declared as legal clarifications by the legislator, namely the amendments with respect to interim profits (*Zwischengewinne*) and equity gains (*Aktiengewinn*).

Furthermore the legislator has complied with a request from the fiscal authorities to have mechanisms at hand to qualify investment funds as tax deferral schemes.

Finally, for the sake of improving the tax registration of foreign special investment funds with the BZSt, non-German special investment funds have to present a professional tax certificate indicating whether their tax figures have been determined in compliance with German tax rules if they have at least one German investor.

German UCITS IV Implementation Act

The most notable envisaged changes in law are aimed at preventing the abuse of tax-structuring options in connection with cum-/ex-trades of shares (*Leerverkäufe von Anteilen*), the redemption of shares on/around the accumulation date (*Leerrückgaben*) and deemed distributed income (*ausschüttungsgleiche Erträge*) which were used in the past in order to achieve unjustified withholding tax advantages (i.e. by means of doubled withholding tax credits). The withholding tax deduction obligation shall therefore be fully transferred to the paying agent/withholding tax obligor. Insofar as the amounts available at the withholding tax obligor are not sufficient to cover the withholding tax amounts (including any auxiliary withholdings thereto), the investment asset pool has to make available such additional funds as are needed to cover the withholding tax deduction obligations.

Non-German reinvesting investment funds should not be affected by the contemplated changes in law but income derived from such funds continues to be declared and taxed in application of the standard tax assessment procedure (*Veranlagungsverfahren*).

Whereas the Annual Tax Act 2010 had already passed the legislative procedure and broadly entered into force on 14 December 2010, so far the draft bill of the German UCITS IV Implementation Act has only passed the Lower House of Parliament and is not expected to be published and thus enter into force before June 2011.



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UK proposed tax changes

Tax residency of UCITS funds

Finance Bill 2011 introduced amendments to the tax residency rules to ensure non-UK corporate UCITS funds can have UK management companies without the risk of becoming UK tax residents.

UK offshore fund tax rules

Draft regulations were published in February introducing a number of proposed changes to the UK offshore fund tax rules which should make them more accessible.

The following summarises the amendments:

- The range of funds that can benefit from the deemed non-trading status for the purpose of computing reportable income has been expanded to include EEA 'Qualified Investors Scheme' equivalents
- The treatment of UK investors in income transparent funds, such as FCPs, has been simplified and the full reportable income calculation has been dropped
- The deadlines for applying for reporting fund status have been extended such that a fund can apply at the end of the first reporting period or three months from the date the fund is first made available to UK investors, whichever is later
- The reported date (relevant for inclusion in tax returns) for investors will be treated as six months after the end of the period irrespective of the actual date
- Funds tracking indices will no longer be required to identify underlying offshore fund positions
- As currently drafted, a form of equalisation will be mandatory for all reporting funds. There are problems with the current draft and this is an area where we hope to see change

Final regulations, taking into account industry comments, are expected to become law in May 2011.

Austrian tax changes

for foreign mutual funds in 2011

The tax provisions of the Austrian Mutual Fund Act and the provisions with regard to capital income in the Austrian Income Tax Act changed in the course of the Austrian Bill legislation for 2011-2014 and became law on 30 December 2010.

Austrian banks brought a lawsuit to the Austrian High Court with regard to the new tax provisions at the end of January 2011. The ruling of the High Court is expected to be published in the coming months.

Two draft laws were published in March 2011 with regard to changes in the taxation of foreign mutual funds.

Final rulings of the Austrian Ministry of Finance are expected after the High Court Ruling in autumn 2011.

The following summarises the major tax changes which became law on 30 December 2010:

- **New scope of Deemed Distribution Income (DDI) for private investors:** DDI comprises interest income, dividends, expenses and 20% realised net gains from financial assets other than debt securities. The taxable part of the net realised gains will increase annually from 20% (with exemption of debt securities-related gains) up to 60% (of all net gains) for funds' financial years starting after 30 June 2011
- **25% withholding tax on capital gains resulting from the redemption of shares in foreign mutual funds:** relevant for redemptions after 30 September 2011 and acquisitions after 31 December 2010
- **Change in the tax reporting system for foreign mutual funds:** no daily or annual reporting to the Austrian Kontrollbank for extra-white funds after 30 September 2011. No annual reporting to the Austrian Ministry of Finance for Austrian tax representatives with regard to extra-white and white funds. After 30 September 2011, foreign funds have to appoint an Austrian tax representative who will perform the annual reporting to the Austrian Kontrollbank in order to maintain the tax optimal status of foreign mutual funds for Austrian investors (transparent funds)
- **No security tax after 30 September 2011 for white and black funds**



Global exposure Regulation on target?

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Over the past ten years, the asset management business in general, and the mutual fund business in particular, has grown significantly. Having more players in the market, asset managers choose to engineer their products in a more sophisticated way in order to be able to offer a unique selling proposition to the client.

In that perspective, the use of derivatives should currently be considered as a mere given, as it enables efficient management on the one hand (e.g. buy one contract and get exposure to a diversified basket of shares), and access to asymmetric and attractive payoff structures on the other hand.

The 2008 financial crisis parameter shift has proven to be a stress test for certain of these derivative holdings, which, in exceptional cases, could not withstand the pressure. It was clear that the usage of such instruments did not always come together with the right level of sophistication at the level of certain risk control departments in the industry. Furthermore, the

UCITS III framework, created to protect the less sophisticated investor, was not explicit enough about the matter, hence not a sufficient safeguard against potential risky behaviour in derivatives. Also, a basic level of standardisation in the risk approach to derivatives was not in place. Hence, Europe decided to raise the bar and to tackle several risk issues involving derivatives usage through the revised UCITS (IV) regulation and other legislation to be expected.

The major strength of the regulatory suite directed at the asset managers, is that the major risks of derivatives usage are thoroughly elaborated in different parts of the legislation. The EMIR regulation should provide



more standardisation on the contractual side, hence more protection against operational hazard, similar to the way in which the GMSLA contractual template has worked for protecting the lender's interests. The liquidity risk needs to be tackled in a liquidity policy, which is mandatory under UCITS IV. The counterparty and the market risk, correctly considered as the top risks when using derivatives, are dealt with in the CESR/10-108, CESR/10-798 and CESR/10-1253 papers, which offer a detailed framework for global exposure (market risk) and counterparty risk calculations.

By providing this level of detail, it is clearly stated that UCITS and their management companies have been restricted severely in their degrees of freedom for dealing with the market risks generated by holding derivatives. In brief, the CESR/10-118 paper details three possible methods: the commitment approach, suited for derivatives with a simple payoff structure, and based on the delta-weighted exposure, and the VaR approach, for more complex derivatives, which comes in two versions: the relative VaR, suitable for those derivatives where a non-leveraged reference portfolio can be defined, and an absolute VaR method, suitable for all other complex derivatives. Although the premise of the paper is that the UCITS has to choose the most appropriate technique, it is very clear from the restrictions set that the sophistication argument and the VaR technique mandatory in such cases will be applicable in most of the cases where non-plain vanilla derivatives are considered within the investment strategy.

By imposing very stringent quality measures to both VaR approaches, like high-frequency back and stress tests, continuous evaluation of input, model quality and output quality, and re-calibration of the model in case it indicates a lack of prediction power, it is clear that this can only be applied by a very mature risk management department, raising the bar in general and imposing a hurdle for less sophisticated asset managers in particular. Also, the limits set to the exposures clearly imply that substantial leverage of any form will be hard to obtain.

As such, all this is perfectly understandable from a regulatory point of view. The main purpose of the UCITS IV regulation is to protect the interests of the mutual fund investor. A UCITS label should be perceived as a passport and a testimonial of good quality management, comparable to the ISO standards in other businesses.

Less sophisticated, e.g. long-only fund managers, who are only using derivatives in the context of hedging out market risk, are not particularly targeted by this additional legislation. The focus is mainly on sophisticated derivative holding strategies, where long does not hedge out short exposure, and where hidden elements of exposures to certain market factors may be embedded in order to achieve the alleged high returns of the strategy. For such strategies, the bar is clearly raised, and UCITS IV global exposure considerations will heighten portfolio managers' awareness in terms of overweighing the risk factors at the time the strategy is set up. Also, the back test of those strategies should not focus on return only, but should include at least the VaR risk measure in order to convince the UCITS' risk and senior management of the UCITS to go forward with this strategy. Of course, this is no guarantee for success: most of the time, the residual risk lies post-stress test in the factors which are not taken into account when modelling the risk. Therefore, the requirement of permanent evaluation should lead the UCITS to progress along the market risk management learning curve. For the leverage part, one can argue, from a conservative point of view, that leverage, in most but not all cases, is to be considered more a concession to the investor's greed rather than a way to offer a product with an optimal risk-return perspective.

So, in the spirit of the ultimate goal of the UCITS IV regulation, the proposal as stated in the CESR papers is genuine and will serve the purpose of having less sophisticated/risky derivative strategies in the UCITS funds, or, in the event that sophisticated strategies are used, increasing risk awareness among the UCITS' (senior) management and having a more stringent and empowered control on the strategy applied. A buyer of a UCITS IV-compliant fund can be assured of a more prudent approach to derivatives. So far, so good.

However, when starting to implement the proposed regulation, certain elements indicate or may lead to a certain degree of sub-optimality.

First of all, the choice of a VaR methodology to approximate the exposure of sophisticated derivative strategies, is reasonably discussable. For such strategies, non-normal return distributions can be expected, including fat tails. For such fat tails, one should be particularly interested in the return distribution beyond

the VaR, as this is the real hard-kicking risk that the UCITS may encounter. A measure like expected shortfall would be more appropriate in such cases. In any case, the regulation does not prevent the risk managers from making use of this measure if they consider this it to be more appropriate, but it comes on top of the requirements.

Also, the assumption that the VaR models should strive for completeness and should capture "*all relevant risk factors with a non-negligible influence in the fluctuation of the portfolio's value*" sounds nice in theory, but may easily lead to over-calibration and low predictive value in practice. More than ever, it is crucial to detect the 'killer factor(s)' and to try to master these factors with a well-performing model, rather than to model all the factors and to end up with a blur. The risk of over-calibration is also implicitly embedded in the 'permanent evaluation' requirement: having too much of a short-term focus on a risk model performance has not always been proven to lead to robust models.

Also, the model should be transparent and explainable, another argument to keep it relatively simple at a first stage and, after gaining sufficient experience with the model, to increase its sophistication gradually.

A second and more fundamental remark to the methodologies proposed is that VaR and commitment approach are not additive, in such a sense that when certain UCITS managed by a particular management company are simple and others sophisticated, the management company cannot consolidate its exposure figures to a single 'global' exposure number at management company level. Most management companies in continental Europe are multi-strategy and will be facing this issue. So, linking the total derivative exposure taken by the management company to, for example, the risk appetite of that same company (e.g. by imposing a limit at company level) becomes a less straightforward exercise. Alternatively, aligning all exposure calculations within the management company to the VaR approach is a possible solution, but comes at a considerable cost due to severe impact on workload and governance requirements.

Thirdly, the regulation is not optimally designed to deal with the specific context of structured funds, which are very popular in the Benelux, French, Italian and several Central European retail markets. The products target

the retail customer by offering the combination of a very defensive fixed income portfolio and an OTC swap, delivering a predetermined pay-off structure to the product at a fixed maturity, financed by the cash flows generated by the fixed income portfolio. The pay-off structure may vary from a plain vanilla call or call spread to a more exotic lookback or digital structure. The proposition of capital protection is particularly attractive in the retail market, and is safeguarded by the fixed income assets, held by the UCITS.

Logically extending the reasoning of global exposure as set out by CESR, certain of these funds may end up using the commitment approach and others may have to use the VaR approach, depending on the complexity of the pay-off structure. There is one big difference with normal funds though: the pay-off structure is fixed in the prospectus of the fund. The pay-off structure is the reason why clients buy (and hold) the product, and cannot be changed in the product's lifetime, as this would breach the client's expectations in the UCITS. What if a breach occurs during the lifetime of the product, e.g. when a swap ends up deep in the money? Does the UCITS have to stop commercialising the product and/or force the client to sell, even though the investment opportunity remains intact? Or does the UCITS have to partially unwind the OTC swap, which will lead to a breach of the commitments of the prospectus due to imperfect hedging? Or is it just acceptable to switch calculation method? None of the solutions seem right, even from a customers' view, yet in the constellation of a capital protected fund, they are the only options.

Also, the requirement of daily calculation of global exposure, on funds with only a contractual ability to be traded every two weeks (due to their buy- and hold character), may turn out to be an obvious form of overkill. However, most regulatory bodies have not yet announced their intentions on the matter, but it can be expected that the regulators will follow the CESR/ESMA recommendations.

Another consequence of the new regulation is the sheer impossibility of bringing leveraged pay-off structures under UCITS, even if they are offered within a capital protection-offering constellation with fixed maturity. The argument can be found in the fact that when the product has a positive run and sees its NAV doubled, there is the possibility that an investor will buy at the



high NAV, a level from where he could lose 50%. In theory, this is indeed possible, but in practice, these funds are bought at launch and held to maturity.

In general, this is quite an unfortunate trend, as, in our point of view, the financial interests of a retail customer are better protected when offered a product with capital protection and 120% of the equity market upside, compared with a classic open-end equity fund on the same market, where the fund manager invests 80% of the assets in equity and 40% long in the future market. Both offer 120% exposure, the structured solution offers downside protection but will breach the global exposure regulation, and the open fund has 120% open downside market risk, but operates perfectly within the global exposure limits. Striving for less complexity in fund management is often, but certainly not always, better.

As the examples have shown, the global exposure regulation will reinforce the current trend in the retail market towards simplicity and transparency, which will lead to more plain-vanilla-oriented structures in the market of capital protection. As a flipside, innovation and attractive investment opportunities in retail offerings using the structured market segment are less likely to occur for that matter. However, in my opinion, the overall balance, should be considered as positive.

To conclude, the whole UCITS IV programme may suffer a major threat: the quality label is appreciated, but comes at a cost of less flexibility. Certain local regulators will not be too keen to enforce compliance with to the

full set of UCITS IV implications on, for example, local (non-UCITS) funds, structured notes and life insurance contracts, hence offering leeway to local players to develop their businesses or even to attract new business from foreign players. Also, the European guidance on non-UCITS (AIFMD) and insurance products (PRIIPS) is still to be expected in its definitive form. More importantly, the clients are not sufficiently aware of the existence of a quality label for mutual funds and the high quality risk control features such a product may bring to the table. As long as clients do not explicitly request the UCITS label or consider the label as a determining factor in their choice for a fund or a fund house, the attractiveness of alternative solutions, which may offer, in a less stringent risk measurement context, a better expected or perceived return, will not fade away. For that matter, Europe should reconsider the lessons learned from MiFID I: banking on the industry to create momentum and awareness about new (and complex) legislation may prove to be a bridge too far in practice.

Hence, the strict regulation on UCITS may, at least temporarily, inspire asset managers and their clients to go in the direction of these alternative solutions, and may restrict the European regulators in achieving what is bottom line the ultimate target of the UCITS IV regulatory suite: offering the right level of customer protection to every single owner of a collective investments instrument in Europe.



Spirit of new regulation

The new derivatives order

How the new derivatives order deeply changes the information workflow inter- and intra-market. How ubiquitous connectivity and information efficiency enable the change.

Philippe Carrel

Executive Vice President, Risk and Trade Management
Thomson Reuters

The Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) deeply modifies the rules associated with trading and using derivatives for investment and hedging purposes. Simultaneously, the global recommendations on derivatives clearing driven by a consultation process under CPSS/IOSCO and the forthcoming EU regulation under the responsibility of ESCB and CESR are widely expected to stick to the spirit and key principles of DFA. The members of the G20 have vowed to foster a unified approach to the key issues exposed by the global financial crash. The new

derivatives order is one area where little divergence has been observed so far. Moreover, the interoperability of markets requires unified rules and processes to maintain the flows of transactions necessary to the economy.

This document outlines the main regulatory changes leading to 'a new derivatives order' and explores the key implications on trading, processing, risk management and compliance in terms of IT infrastructure and communication workflow.

A. What is changing?

1. New regulations

The main endeavour is to obtain that most derivatives contracts are centrally cleared so that market prices can be made public with higher levels of transparency. In doing so, positions would be marked-to-market and variations periodically settled between buyers and sellers under the responsibility of their respective clearing members, so that the overall credit exposure would become transparent too. Today's bilateral agreements require one party to face credit risks while the other side bears replacement risks, with both being exposed to settlement risks. In a centrally cleared system, clearing members are responsible for maintaining variation margins between anonymous buyers and sellers and settle those differences among each other before reverting to their customers.

The Dodd-Frank Act defines all derivatives as 'swaps' or 'security-based swaps'. The Commodity Futures Trading Commission (CFTC) regulates the former while the Securities Exchange Commission (SEC) oversees the latter. Whether they are actual swaps, options, collars or other combinations, the DFA terminology refers to them as swaps, the only differentiation being in the underlying; security, index or loan-based swaps qualify as security-based swaps. Both regulatory authorities have started to publish the rules of a regime where swaps will eventually be mandatorily traded through exchanges, processed through centralised confirmation platforms and cleared through a Derivatives Clearing Organisation (DCO) in the case of swaps and/or Centralised Clearing Agencies (CCAs) if they are security-based swaps; generally referred to as clearing houses, often known in Europe as Centralised Clearing Counterparties (CCPs).

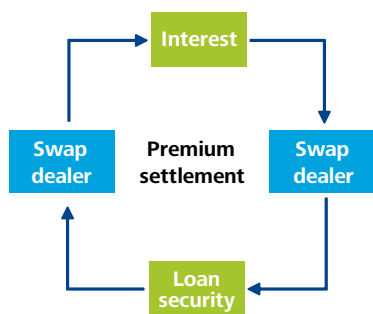
As market participants need to register with either the SEC or CFTC, those will be in a position to enforce capital and liquidity requirements in addition to margin requirements for uncleared swaps. For trades cleared through CCPs, collateral levels and variation margins are defined by the CCPs themselves.

The EU proposals are very similar in principle: systematic use of CCPs, independence of CCPs from exchange venues, responsibility and accountability of the clearing members, variation margins and special capital charge for non-cleared OTC contracts. In addition to the U.S. regulations, which require trade prices to be publicly disclosed "*as soon as technically practical*", the EU proposes to report all trades to central repositories; a proposal which has received some push back from the Investment Management Association (IMA), which is concerned about excessive centralisation. The EU Commission also wants to extend the ruling to exchanges and trading venues, requiring them to be mandatorily MiFID-compliant in terms of transparency and trade disclosure rules. Therefore, CCPs and trade repositories are expected to be governed by the European Market Infrastructure Legislation (EMIL). The EU is also preparing a Market Abuse Directive (MAD) that would allow the regulators to enforce traded limits in areas where the markets appear excessively risky. While abiding to a similar spirit, the EU proposals appear to be more restrictive than the rules outlined under the DFA framework and are further complicated by the prospect of supervising independent national markets through central European regulatory entities.

2. New connectivity

It did not come as a surprise to anybody close to the matter that what was expected to be a single additional step within trade clearing processes will end up being a profound change of the entire pre- and post-trade workflow. The diagram below, which represents the ultra-simple workflow of a bilateral agreement, will become much more complicated than the simple insertion of a CCP between the two dealers.

Bilateral agreement settled OTC

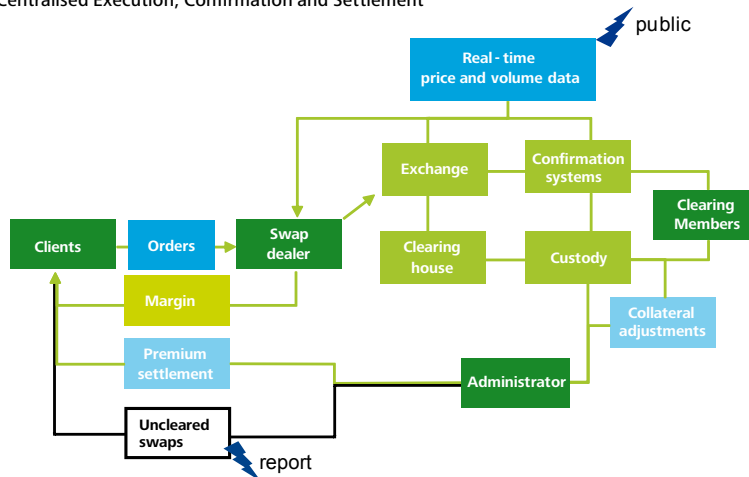


The concept of decoupling the exchange venues from the confirmation platforms and clearing counterparties imposes three distinct layers of simultaneous communication. Reporting prices and trade accordingly near real-time adds a fourth.

The management of variation margins imposed on the clearing members further complicates the process in the case of long lifecycle products with multiple cash-flows, contingent cash-flows, underlying (security) adjustments, collateral valuations and netting rules.

The following diagram illustrates the additional level of complexity that will result from the 'new derivative order'. To ensure that settlements are properly carried out, the various entities will need to agree on pricing models, curve methodologies, data relating to the underlying and pledged collateral, cut-off time and prices, netting and reconciliation rules. These tasks may be further complicated in the case of default swaps with reference bonds or loans which may lead to discretionary decisions on valuations.

Centralised Execution, Confirmation and Settlement



While the above diagram appears fairly complicated compared with bilateral agreements, it remains a representation of a bare minimum information workflow. Maintaining the interoperability of markets in these conditions will require a spider network of links and reconciliations between the exchanges, clearing houses, collateral management agents and counterparties involved that is barely possible to represent as of today.

This will have durable and profound implications on the IT infrastructure of the financial entities qualifying under DFA terminology as private funds, swap dealers, commodity pools, swap market participants or major swap dealers; almost all significant players.

The remainder of this document examines the changes that must be implemented throughout the enterprise to the IT infrastructure as well as to the risk management and information workflow.

B. New information workflow

The following diagram summarises the main tasks that will be required whenever derivative orders are placed. Yellow boxes refer to the tasks that are to be carried out internally, whereas grey boxes are information flows outside trading firms or so-called 'swap entities'.



1. Trade creation

The first important task when dealing or trading in derivatives (swaps) will be to identify them so they can be routed to a proper execution venue and allocated to the appropriate legal framework. Not only the underlying and the nature of the swap are key to allocation (whether it is security-based or not) but its purpose and the dealing counterparty also impact processing. For example, the Dodd-Frank Act prohibits FDIC-insured entities from engaging in swap transactions other than for the purpose of “*bona fide hedging or traditional banking activities*”. This requires the internal system to be able to trace (i) the value of the underlying exposure to be hedged, (ii) some sensitivity threshold that can justify the hedge, (iii) the suitability of hedging instrument(s) and (iv) the pledged collateral that will be necessary.

For banks and broker dealers, this also means keeping records of the client counterparty data so that they can justify an exposure requiring a hedge. All transaction data and track records of hedge efficiency will be necessary as well.

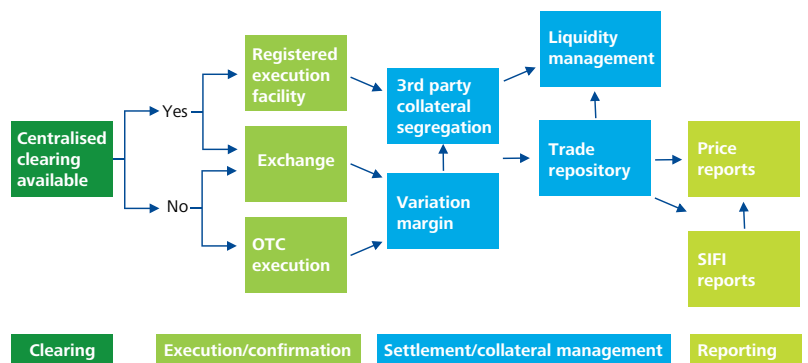
2. Routing and execution

Before an order can be routed to an execution venue, it is necessary to know whether it can be cleared by a centralised clearing counterparty (CCP) or derivatives clearing organisation (DCO). If the instrument is centrally cleared, then it must be executed through a registered exchange or execution facility. The (non-swap dealer) counterparty of the swap dealer can request clearing and is free to choose the clearing entity. Depending on the chosen exchange and clearing counterparty, the swap will be subject to different trade reporting, margining and collateralisation rules as shown in the diagram on the right.

The rule requires non-discriminatory clearing of all swaps undergoing centralised execution, which means that exchanges are no longer tied up to their own clearing houses and must openly communicate in real-time with any CCP or DCO chosen by their members or their customers.

SEC. 716. Prohibition against federal government bailouts of swaps entities.
 (A) prohibition on federal assistance.—
 Notwithstanding any other provision of law (including regulations), no Federal assistance may be provided to any swaps entity with respect to any swap, security-based swap, or other activity of the swaps entity.
 (d) only bona fide hedging and traditional bank activities permitted.—
 The prohibition in subsection (a) shall apply to any insured depository institution unless the insured depository institution limits its swap or security-based swap activities to:
 (1) Hedging and other similar risk mitigating activities directly related to the insured depository institution’s activities.
 (2) Acting as a swaps entity for swaps or security-based swaps involving rates or reference assets that are permissible for investment by a national bank

Processing of cleared and uncleared swaps



Bilateral executions and OTC settlements remain possible for swap transactions that have not been selected for mandatory centralised clearing, but they will be subject to variation margins and collateralisation rules defined by the SEC and CFTC as well as specific capital and liquidity requirements and disclosure rules.

SEC. 723. Clearing.
(a) clearing requirement.—
“(1) in general.—
“(A) standard for clearing.— It shall be unlawful for any person to engage in a swap unless that person submits such swap for clearing to a derivatives clearing organisation that is registered under this Act or a derivatives clearing organisation that is exempt from registration under this Act if the swap is required to be cleared.

3. Processing

Important changes are foreseen in the post-execution confirmation and settlement process. Following execution, the email consent and confirmation process will be replaced by a straight-through novation consent process, which is expected to be faster and more transparent. It requires changes in the trading process, in which pre-trade compliance and credit checks are carried out before trade confirmation. Therefore confirmation now precedes settlement.

The main difference between bilateral settlements and centralised clearing is that the end buyer and seller remain anonymous to each other as both trade against the clearing house where they are represented by their respective clearing members. In the event of unconfirmed settlement, most derivative instruments would not be fungible enough for the clearing member to unwind a trade or efficiently replace the faulty counterparty. The clearing member and ultimately the CCP would thus bear risks on behalf of their clients. If this were to happen in adverse market conditions, it could even lead to systematic risks as it is likely that many dealing entities would fail to meet their settlement credit checks and that the market depth and liquidity would quickly vanish.

In order to minimise the back-logs of unsettled deals (liable to special reporting and liquidity requirements), pre-trade compliance checks will need to be carried out in real-time, before confirmation, and be strictly aligned to post-trade checks. This requires valuations to be available on demand, as well as tools for immediate reconciliation of limit utilisations and net collateralised exposure.

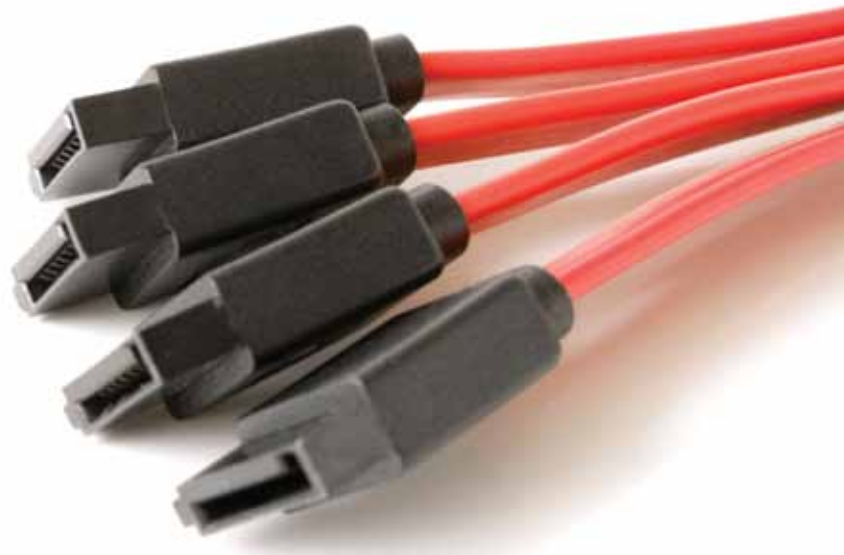
For the remaining OTC trades, not centrally cleared, new initiatives to bring transparency through bilateral clearing and collateral management systems are similar to those used for repos and securities lending.

Implications of these very important changes on the IT infrastructure of all market participants are further developed in paragraph 5, on lifecycle and collateral management.

4. Trade repositories and price report

The proposals from the European Commission, consistent with Title VII of DFA, require that all OTC derivatives and swaps transactions entered into by financial and non-financial firms be reported to trade repositories and made available for publication of aggregate positions and statistics. The rules are broadly similar on both sides, except that the U.S. would also require the publication of all uncleared OTC trades while the EU would accept a threshold. The U.S. also insists on real-time publication, while the timing has not yet been precisely defined in the EU.

Each party needs to report, including the end buyer or seller of a contract. Required information involves details of the swap, price, notional, maturity and value date, trading time and counterparties involved. A number of elements will need to be contributed but will not necessarily be made publicly available. They involve trade details such as broker, trader, desk, premiums and rebates, cash-flow streams and data involved in the calculation of prices. For security-based swaps, additional details need to be provided, involving the description of underlying securities and corporate events of previously reported security-based transactions. This clearly raises the need for a reference securities master database shared by most providers of information to trade repositories with a process for fast reconciliation.



Under DFA, all participants are required to maintain daily records of all communications leading to transactions, including mails, emails, instant messages and telephone recordings. An audit trail for trade reconstruction is also required.

In addition, the CCPs are required to provide the details of each contract, settlement and clearing agreements, fees, pricing and margin requirement calculations, as well as daily price, volumes and open interest.

5. Trade lifecycle management

The concept of mandatory clearing is to bring credit risk transparency and control to the market. When credit exposure is directly managed between clearing counterparties and variation margins are promptly settled, the market is able to scale up without loading up additional risks on counterparties. For this concept, which underlies futures markets, to work, the following essential conditions need to be met:

- Financial instruments are fungible so that a client unable to meet margin requirements can be promptly replaced by another
- The spot value of the underlying is publicly known and unquestionable
- The forward value of the contract is equivalent to the spot value plus a transparent cost of carry
- Clearing brokers (or members) can track the collateralised net exposure of their clients in order to obtain timely margin adjustments

Converting OTC instruments that were initially created as bespoke bilateral agreements into fungible instruments to be processed as swaps as described by the Dodd-Frank Act will require a long and progressive effort of standardisation and calibration to find a common

measuring unit. Fixed income derivatives, for example, are likely to be converted into bond equivalents, equity derivatives into index equivalents, and so on. Further complicating the processing of security-based swaps is the fact that the value of the underlying is periodically impacted by lifecycle events of a predictable (corporate events) or unpredictable (credit events) nature or path dependents (option strikes, barriers, conversions). In order to maintain a generally accepted spot and forward value over long periods, valuations will require continuous reconciliations of static data and information among all market participants.

Marking to market instruments for which there is no market is no new challenge to clearing houses used to relying on proxies and interpolation methodologies. However, the non-discriminatory clearing rule will require them to align their data, methodologies and processes in order to maintain the market interoperability.

The management of collateral under these conditions will be further complicated by the fact that different instruments are traded and cleared through different means. The resulting fragmentation of collateral across venues and silos will challenge clearing members and their ability to address the issue will set the pace of changes.

According to Financial Services Research (1), collateral management specialists such as JP Morgan, BNY Mellon or SGSS have embarked on global collateral management projects to create consolidated views of client collaterals across clearing houses, OTC markets and jurisdictions.

C. Ubiquitous connectivity for new complexity

Clearly, operational complexity is on the rise. Impressive undertakings by governments and regulators to make markets less risky and provide transparency on prices and credit exposure to all participants can restore confidence and empower them with systemic-risk control mechanisms—or it can result in total chaos. What will make a difference is whether the additional information required is efficient and manageable.

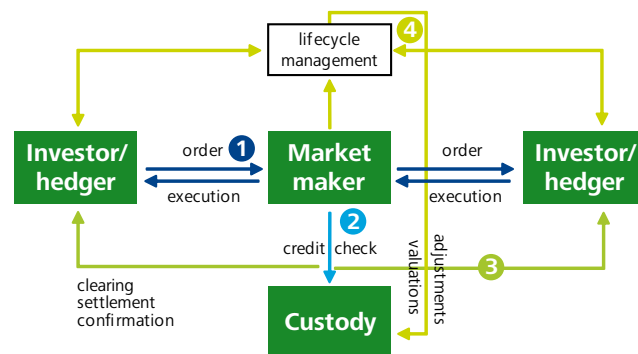
1. New complexity

The new rules raise the volumes, breadth and depth of information (data, cash flows, messages or valuations) to be processed to unprecedented levels. Be it from the point of view of swap counterparties, dealers, major participants, CCPs, providers of liquidity or trade repositories, multiparty communications must become constant, universal and synchronised to be efficient. If the numerous entities involved fail to exchange information efficiently and in a scalable manner, then the complexity that accompanies the new regulations could bring more opacity than transparency, encourage regulatory arbitrage instead of preventing it and even jam the markets if high volumes cannot be processed.

The graphics below are high level descriptions of the typical communication flows involved in OTC trading and bilateral settlement, compared to exchange-traded and centrally cleared transactions. The main difference is that end counterparties remain anonymous so that risks are shared by clearing members who in turn limit their exposure to their clients by way of variation margin management. To keep the diagrams relatively simple and observe the changes strictly from a communication workflow point of view, we have ignored the likely presence of executing brokers, proprietary dealers, prime brokers and fund administrators.

In this simple workflow, the market maker or proprietary dealer bears the credit risk and embedded market risks of the clients, which may net out or add up, create hedging or funding gaps. Settlements and lifecycle events are managed directly, the creditworthiness of the end client and the riskiness of their positions are merely reflected in risk-weighted exposure measurement for economic capital allocation. As a result, risk increases with volume and volatility.

Diagram 1: Typical communication flows in bilateral agreement



- 1 Order and notification of execution system. Typically integrated and capable of processing volumes largely exceeding activities
- 2 Post trade credit and limit system. Typically independent from front and back office or outsourced. Scalability depending on custody
- 3 Trade processing system. Typically integrated until trade capture, then batch allocation and periodic event management
- 4 Lifecycle management, payments, collateral adjustments, periodic valuations, corporate events, terminations. Volume bottleneck

As observed in 'Diagram 2' below, in an exchange-based trading and clearing system, risks are settled between clearing members, themselves responsible for exchange members and eventually for the end investors buying and selling the contracts. The margin management process is designed to let trading volumes increase without loading up additional risks since variations are promptly settled at a frequency which depends on market volatility. This concept has allowed future markets to grow and prosper since the Chicago Butter and Egg Board was created in 1898, in spite of information scarcity, credit and price opacity and high volatility of the underlying.

At trade creation, the investor, the broker, the dealer and the clearing member need to be aware of the origin of the order, the trade justification, the nature, value and location of collateral and the limit utilisation.

Following execution and notification, all credit and post-trade suitability checks must be verified for confirmation and eventually settlement. This requires a comparison of the value of the contract added to previous positions with pledged collateral, and a recomputation of net

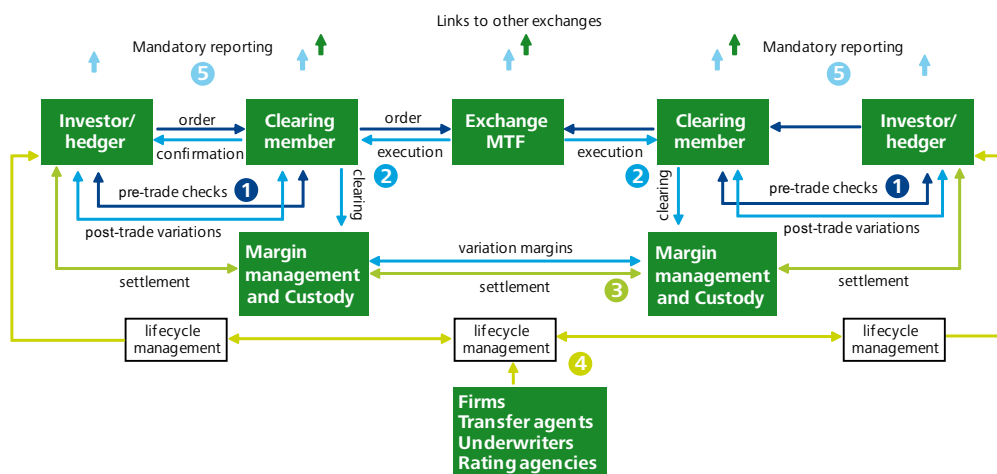
limit utilisations which may involve items in custody at multiple venues, other jurisdictions or even OTC. As confirmations are also subject to post-allocation suitability tests and MiFID-like rules, the blocs or deals will have to be pre-allocated before confirmation. This final step is likely to require hedge efficiency back-tests.

Moreover, long-lifecycle products which involve contingent payments, termination clauses, corporate events and cash flows of diverse origins will need to be maintained synchronously by the whole chain of market participants. This last requirement is critical to the ability of the markets to scale up and absorb the bulk of currently traded volumes.

2. Ubiquitous connectivity

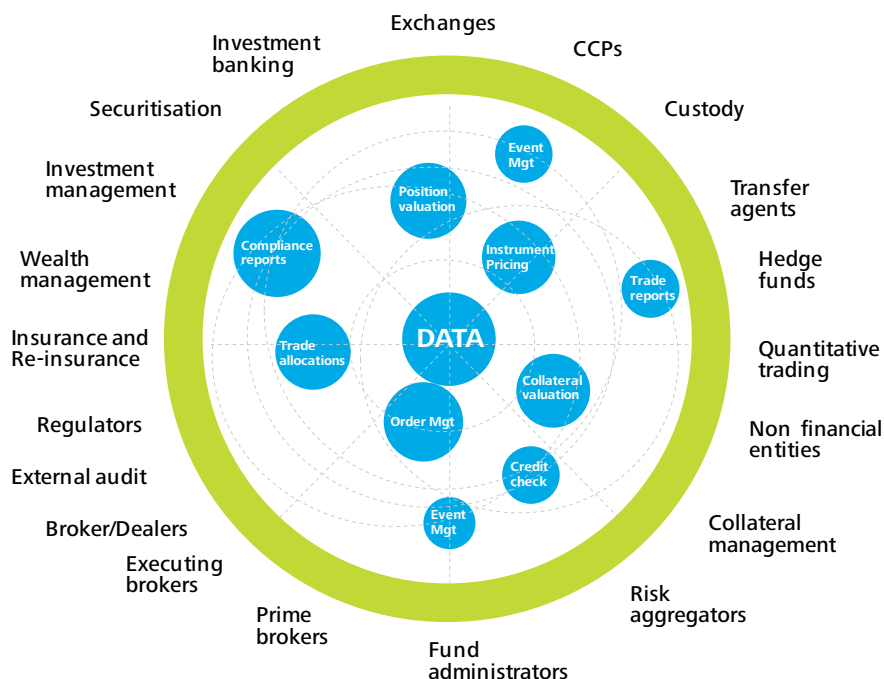
It is highly unlikely that the above developments can take place within the existing IT infrastructure of most banks, market makers, dealers, collateral managers and custodians. Although many of them have recently invested in modern, high performance technology, this was designed to speed up the processing of the widest possible breadth and largest possible volumes of bilateral agreements. Series of bilateral agreements managed

Diagram 2: Typical communications in exchange and centrally cleared system



- 1 Order and notification of execution system must now involve pre-trade credit and suitability checks
- 2 Post trade variation management must involve net collateralised valuations reconciled with clearing agents, limit and credit management
- 3 Trade processing system now decouples settlement from confirmation due to clearing member accountability
- 4 Lifecycle management events and payments must now be synchronised between clearing agent, custodians and end investors
- 5 Mandatory reporting must involve value, trade details, market conditions and pricing parameters

Data integrity and shared valuations for ubiquitous connectivity



through networks of point-to-point communications depend on processing capability and on internal ability to manage exceptions. From 2004, when regulatory authorities started to point out backlogs of unsettled deals, until 2008, when derivatives volumes started to recede, no one could anticipate that market makers would lose control of settlements, valuations and collateral management. As a result, connectivity performance now needs to be considered horizontally, across external silos and third parties, as opposed to vertically within their own back-office services.

The new derivatives order requires full transparency of valuations, thus equal access to data with equal performance, to all participants and at all times. The diagram above outlines how data and valuations must drive the trading, settlement and risk management processes to allow the markets to perform and grow in volume and diversity. It highlights the need for a new generation of connectivity.

The new regulatory driven and risk-averse approach totally modifies the workflow. For example, new orders depend on net collateralised existing exposure and must go through suitability tests before being validated. This might have been a discretionary approach within financial firms in the past, but the main difference is that these tests now need to take place formally and across multiple participants. This exponentially multiplies

the quantity of data and integrity checks necessary. The same phenomenon is observed throughout the event chain; for orders to be confirmed, for example, they must be settled. It means that the respective back-office departments of the portfolio administrator, the clearing member, the custodian and the potential prime brokers and lenders would have communicated several times back and forth and generated multiple transfer and payment messages. If some repos are attached to the deal, more complexity is to be expected.

The most likely consequence is that small size managers, hedge funds and wealth managers will outsource a sizeable share of their IT operations, while larger ones will have to rethink connectivity throughout. Not only the market efficiency but also their interoperability is at stake. In the aftermath of the May 2010 so-called 'flash-crash' incident which saw markets lose control of their order generation systems, exchanges and regulators want to impose liquidity obligations, trading limits and minimum tick sizes adjusted to trading volume. This would require more than synchronicity—it would require exchanges to operate as one.

3. From cloud computing to cloud communications

Cloud computing means that instead of installing and maintaining applications in one proprietary system, operators rent some space and remotely access servers from wherever and whenever they need. As pictured by

Philip Delves Broughton in the Financial Times (4), *"the cloud is Facebook, Zynga or Gmail"*. The cloud is iTunes, internet banking, instant messaging. Proprietary content remains in everyone's system, but services and provision of metadata, tools and storage space are hosted. As a result, communication is standardised, immediate, global, ubiquitous and reliable. Volumes and especially the number of network members can expand.

This is the type of approach that the financial markets will inherit from the new derivatives processing order inspired by the global deployment of new regulations.

4. From information efficiency to market efficiency

The Efficient Market Hypothesis (EMH), which assumes that all available information is somehow factored into traded prices, had long been invalidated by cross-asset trading, global arbitrage opportunities and the inflation of available information. However, a low latency pricing, trading, messaging and valuation network cloud now would place all participants on the same level through non-discriminatory access to market intelligence.

By opening an unrestricted exchange of financial ideas, data, liquidity and allowing the interoperability of markets, the cloud creates information efficiency. By enhancing the efficiency of information and of all the components of market intelligence, the cloud re-approaches the very conditions of the EMH, the basis of all modern financial theories and practices.

Accessing numerous trading venues and liquidity pools is the only way to provide the levels of transparency, low latency and price integrity that the new regulation imposes. The market fabric provides proximity to markets to meet latency sensitive requirements if it allows for trade and processing services to reside on the same platform as pricing and valuations, credit exposure management or data publishing. These are the conditions of pricing and information integrity.

D. Conclusion: of regulation, communication and market efficiency

The new derivatives order clearly demands a new approach to financial information and inter-market communications. Exchange trading and price reporting are expected to provide price transparency, centralised clearing is designed to control credit risks and concentrations independently of volume trades. The main consequences on global derivatives activities and how financial instruments will have to evolve are yet uncertain, but it appears that the capability of all participants to participate in a network enabling efficient exchanges of financial information is absolutely critical to the success of the global endeavour.

All countries, all jurisdictions and all industry segments are concerned. The market interoperability is at stake. To limit the credit exposure to a minimum, dealers and clearing agents will now operate on a variation margin base as opposed to bearing risk-weighted exposure at all times. As CCPs will progressively replace bilateral agreements, a cloud of financial information and trade messages need to link the various participants of the industry as a community, no longer business segments. Communication networks will therefore develop horizontally, to reach an ever increasing diversity of markets and participants. Business growth will therefore depend on the capacity of each one to link to the network, to participate in the cloud.

The challenge is daunting. Computer technology may already allow for those changes, but the key to market efficiency will lie in ensuring that information is efficient. To ensure its efficiency, information needs to be made non-discriminatorily available to all participants, be provided with equal latency, and link markets around the globe as one multi-node trading venue.

References:

- (1)FSR Financial Service Research, Q3, October 2010, Global Collateral Management and Liquidity Support
- (2)The Dodd-Frank Act, Title VII, Wall Street Transparency and Accountability
- (3)Draft Proposal for a Regulation of the European Parliament and of the Council on OTC Derivatives, central counterparties and Trade Repositories.
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Using fund shares as collateral will create new distribution opportunities

Sergio Venti

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Clearstream

It has become commonplace to argue that investment funds substantially differ from regular securities. Difference at product level is beyond dispute, however practitioners often disagree on the intrinsic nature of a fund share versus bonds or equities.

A country's regulatory structure ultimately determines what qualifies as a security, and the operational impact of this decision will not be neutral. The fungible nature of securities allows their mutual substitution and, by extension, their use as collateral as a way to mitigate credit risk in financial transactions.

In a period when many have expressed concern about the prospects for international economic order, the lightest form of financial innovation appears suspicious and industry players accept, by and large, the basic premises of 'back to basics' or 'keep it simple'. The undisputable wisdom of these assertions should not obscure the unexploited strengths of UCITS-regulated funds, nor should they prevent UCITS from contributing to a stable financial environment.

This article starts with some general consideration on collateral management, in light of the structural changes inherited from the 2007 banking crisis. We then assess the opportunity for UCITS funds to play a more active role in post-crisis collateral management activities. We finally explore concrete scenarios, where funds could altogether collateralise a financial transaction and, by doing so, generate additional appetite towards UCITS for asset liability management needs.

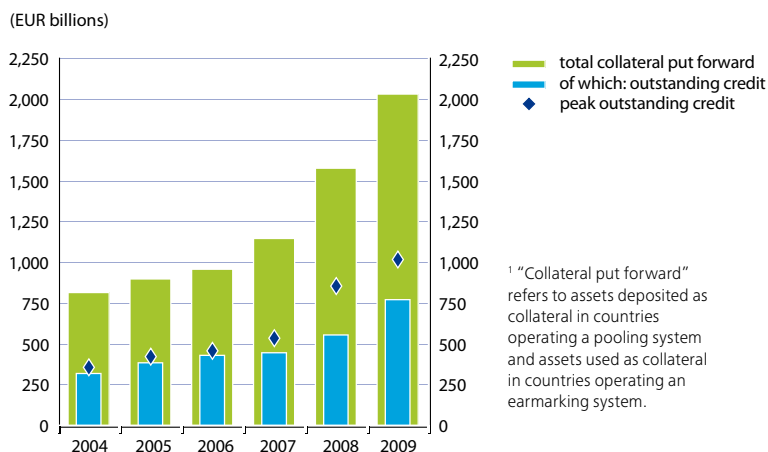
The aftermath of the 2007 banking crisis and the impact on collateral management

Repeated bank failures triggered an urgent need to restore confidence amongst financial institutions, especially within interbank lending, where depository institutions lend to and borrow from each other in order to meet reserve requirements. The threat of defaulting counterparties undermined traditional liquidity channels and raised the need for security as market participants hedged themselves against credit risk.

Collateral management, the function typically used for reducing credit risk in unsecured financial transactions, became a vital component in both long and short-term financing. With the general shift away from uncollateralised transactions, its immediate effect has been a generalised search for highly rated financial assets.

The following diagrams illustrate the growing tendency from market participants to engage in financial transactions that systematically generate a demand for highly rated collateral:

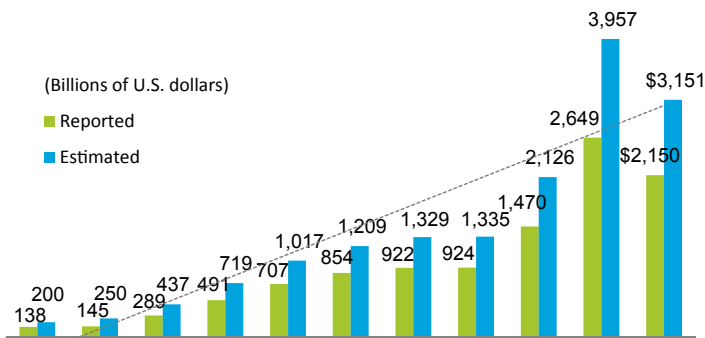
Collateral put forward in Eurosystem credit operations vs. outstanding credit in monetary policy operations¹ (source: ECB)



Total repo activity 2001-2010 according to European Repo Market Survey (Number 19 – June 2010)

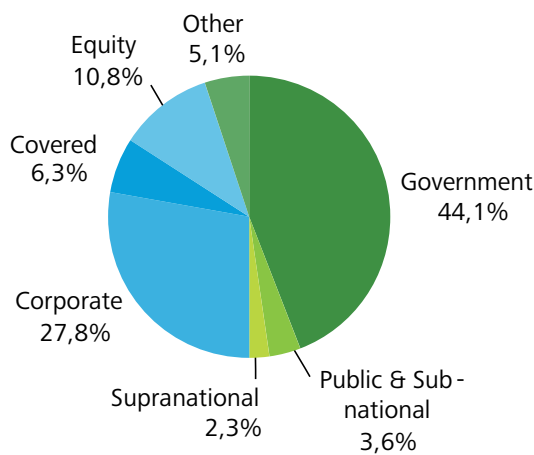


Growth of value of total reported and estimated collateral according to ISDA Margin Survey 2010



While OTC derivatives are mainly collateralised with cash, Eurosystem operations and repo activities favour, to a large extent, fixed income securities:

Tri-party repo collateral analysed by type of collateral, according to European Repo Market Survey (Number 19 – June 2010)



The turmoil affecting European debt issuers raised natural concerns around the soundness of the above distribution. Growing pricing disparities of sovereign debts in the eurozone and valuation problems associated with corporate bonds are encouraging market participants to explore new avenues. There are valid reasons to believe that financial institutions would welcome new and large sources of collateral, next to traditional securities.

UCITS as an eligible collateral instrument

With €17.5 trillion of worldwide assets under management, the investment fund industry can position its products as a valid alternative to cash and fixed income securities. The combination of a well-established UCITS regulatory framework, high capital preservation and strong liquidity profile supports their attractiveness as a way to control credit risk.

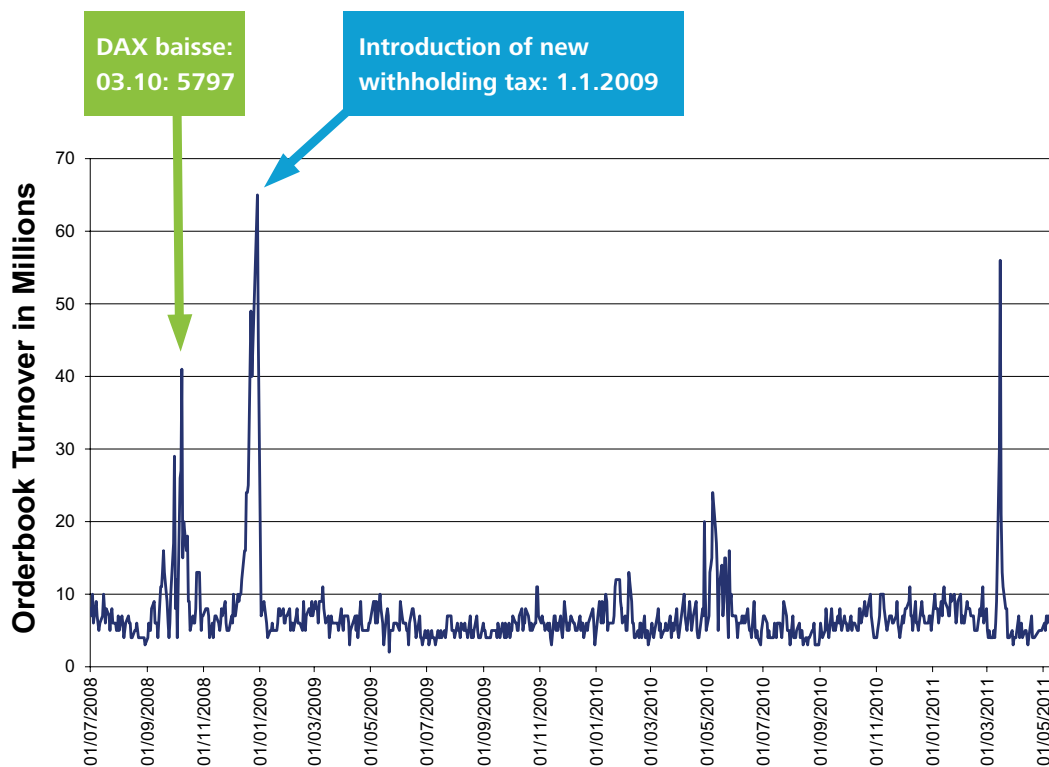
Flexibility from collateral receivers will be crucial in generalising the use of funds as collateral, though several arguments would support this decision. Collateral valuation would be based on the Net Asset Value (NAV) of the fund. The minimum NAV frequency for UCITS is twice a month, however, the majority calculate

a daily NAV. Some of these funds are listed on the Frankfurt Stock Exchange and are included for trading on the open market, hence offering additional price transparency during the trading hours, from 9.00 a.m. to 8.00 p.m. Market makers known as 'specialists' set price estimates on a continuous basis in combination with volume, and within maximum spread limits. This valuation environment is far more transparent and reliable than the one typically used for bond pricing, which still heavily relies on bilateral quotes from market makers.

Another crucial requirement for collateral receivers is the speed at which collateral can be liquidated. Understanding the market liquidity for a given instrument is key, as it indicates the ability to quickly sell the collateral in case of counterparty default. The liquidity indicator generally used for equities, the Average Traded Volume (ATV), carries the advantage of being readily available and consistently interpreted across market players. The higher the ATV, the more liquid the market will be for a given stock. Equities with a high ATV are also likely to be less volatile as much larger trades would have to be made to affect price. On the contrary, liquidity indicators for bonds suffer from their more opaque pricing mechanism. Bid-ask spreads are widely used, however, the data is not always readily available and is open to interpretation, hence making it a less forthcoming indicator than ATV.

Investment funds benefit from a concrete advantage: liquidity is guaranteed by the fund management company on the primary market. Redemption orders always find a natural buyer in the person of the issuer. Sizeable and unforeseen redemptions can be rejected or partly executed, however, under the specific conditions defined in the fund prospectus. Decisions to impose gates or so-called side pockets are therefore the ultimate liquidity risk incurred by entities accepting funds as collateral. While this occurred during the financial crisis, it was predominantly a hedge fund phenomenon. The insufficiency of cash, to meet redemptions without selling assets or borrowing money, was a direct consequence of aggressive investment strategies (e.g. funds taking positions in distressed assets or special situations). Such characteristics can be identified well in advance and factored into the remuneration levels of the principal exposure. So-called 'plain vanilla' UCITS funds

instead went through the crisis without evident signs of liquidity shortfall, and managed sizeable redemption flows on a daily basis. Besides, funds available on the secondary market increase the liquidation possibilities for collateral receivers. The mutual funds order book turnover illustrates the resilience of the stock exchange towards unexpected reactions in special market situations:



Ironically, the main obstacle for using funds as collateral results far more from their peculiar operational environment, rather than from market risk considerations. European funds predominantly operate under the so-called 'Transfer Agency (TA) model', whereby fund units are issued on the primary market via stand-alone shareholder registration systems. This is ill-suited for collateral management purposes. Absence of speed in transferring and pledging fund units in favour of a collateral taker makes the process far too cumbersome and risky for both parties. Some domestic fund markets, such as Germany, have historically

integrated funds within their domestic financial infrastructure (i.e. the national CSD). This allowed funds to operate like regular securities, hence opening the way to using them as collateral. Fortunately, the most experienced European fund centres (Luxembourg and Ireland) progressively managed to embrace both models, hence offering fund promoters the ability to distribute their products across both environments (TA and CSD).

Having established the conditions for funds to be used as collateral, the next section turns to the concrete scenarios under which this would eventually occur.



The relevance of this question mainly comes from the innovative flavour of the subject. No live example has so far been observed, let alone generalised into a liquid market. The next section provides a few thoughts, based on real client engagements, on the way market players are assessing this opportunity.

From cash transformation to structured products: the various options at hand

The 2010 ISDA Margin Survey¹ shows that more than 80% of the value of OTC derivatives is collateralised with cash. Government securities come second with less than 15%. This widespread use of cash collateral has generated more than one concern, particularly for asset managers investing in OTC derivative contracts.

Each time an asset manager receives cash collateral as a guarantee for a principal OTC derivative contract, the guarantee paradoxically turns into a risk. At contract maturity, the cash will need to be returned with an interest rate agreed between both parties. The cash therefore has to be reinvested during contract duration, in order to return at least the remuneration requested

by the counterparty. Multiply this by the number of counterparties and the total outstanding value of OTC derivative contracts, and the risk quickly becomes systemic.

There is a case in which replacing this cash with money market funds satisfies the requirements of both parties and allows a better control of the systemic risk:

- The asset manager would be freed from searching for a return on its cash collateral, as its counterparty would be remunerated directly by the money market fund. The asset manager would also benefit from a very stable, easy-to-value and highly liquid collateral type, whose settlement cycle is as quick as T+0
- The collateral giver would receive the accruing daily dividends of the money market fund, and the collateral would be ring-fenced against an eventual default from the asset manager (cash collateral would instead be difficult to separate from the liquidation mass)

¹ http://www.isda.org/c_and_a/pdf/ISDA-Margin-Survey-2010.pdf

This very simple mechanism would, in addition to increasing the safety of the financial system, position money market funds under a new light, with significant new distribution opportunities thanks to its potential re-use.

We also came across institutional investors seeking protection on their proprietary investment fund holdings. Insurance companies, for example, can buy an option giving a right to buy or sell a defined quantity of a fund at a given price at a given date. The intention of both counterparties to collateralise this contract with funds must be understood in the following light:

- The option buyer will favour a collateralisation with the same asset class as the one for which it is buying protection. This ensures a closer alignment between the collateral and the principal exposure, and hence a safer risk monitoring process
- The option writer sees it as an opportunity to re-use existing fund holdings and, thanks to this possibility, generalise the use of structured products linked to funds

This last scenario is particularly relevant for banks and insurance companies, in the context of Basel III and Solvency II respectively. Under these upcoming regulations, the capital charge associated with investment funds will soon become prohibitive, particularly where the fund is not sufficiently transparent to perform detailed look-through analysis. Locking the future price of a fund or re-using fund units as collateral might substantially reduce the capital consumption of these holdings, without having to break the confidentiality associated with the fund's investment strategy. These operations will ultimately increase the attractiveness of funds to institutions that would otherwise turn to more 'Basel III' or 'Solvency II'-friendly assets. The possibility to mobilise fund units and re-use them as collateral therefore becomes an incentive to hold these products in the first place.

Conclusion

This paper argued in favour of four statements:

- The financial system welcomes additional sources of collateral, in the form of safe and transparent products, to efficiently secure transactions involving credit risk
- Appropriately selected funds are not less reliable than bonds, equities or cash in terms of collateral valuation and liquidation. The opposite is often true.
- Funds require an efficient operational environment, in line with regular securities, in order to be used as collateral
- Immobilised investment funds holdings will become a capital intensive asset in the near future

These controversial statements will lead to an equally controversial conclusion: unless funds receive all the attributes of regular securities, some investors might shift to competing asset classes. Using them as collateral will instead multiply their usage and therefore increase their consideration by players who would otherwise ignore them.

The 2010 ISDA Margin Survey shows that more than 80% of the value of OTC derivatives is collateralised with cash.



Decrypting hedge fund indices

Pictet Alternative Investments

There has always been a need to compare one's investments to a reliable benchmark or peer group. Hedge fund investors are no different in that they too seek to identify a benchmark that offers an indication of their hedge fund portfolios' performance relative to a representative reference.

Yet hedge funds are absolute-return investment vehicles and the concept of relative performance becomes counter intuitive when defining a hedge fund index. Furthermore, the complex nature of the hedge fund universe that such indices must account for in order to depict an accurate picture of the industry creates considerable deviations in the representativeness of these indices in terms of their relevance and performance.

Hedge fund index construction

To identify these deviations, one must begin by looking at how hedge fund indices are constructed. The process involves a hedge fund manager, the hedge fund database provider and the index provider. First, a hedge fund manager reports a description and the performance of the hedge fund to a database provider. However, as hedge funds are private placements, there

is no obligation for the manager to report these details and therefore the choice of database and which fund is reported is completely voluntary and self-selected. Understandably, a manager would be less inclined to report a poorly performing fund and would typically only disclose the details of his top performing fund(s). As a result, the hedge fund universe of around 7,000 hedge funds according to Hedge Fund Research shrinks and represents only those funds that are reported.

Next, the hedge fund database aggregates the various funds that have been reported and either gives index providers access to its database or constructs an index itself. Typically, the database requires the hedge fund to describe its investment universe, terms and conditions, assets and/or strategy/style. This enables an index provider to construct an index on the basis of a set of arbitrary criteria.

Hedge fund universe is diluted through selection criteria and segmentation

Selection criteria for including funds in an index differ from one provider to another. One may, for instance, exclude any hedge fund with less than a 12-month track record, or funds that manage less than US\$200 million. Other criteria that vary between providers can also include constraints on operations, underlying financial instruments or liquidity schedules. In some cases, index providers may mandate a full due diligence of the reporting hedge funds. In the creation of subsequent sub-indices, providers further segment their universe to offer either investable and/or non-investable indices. The former include only funds that are open to investment, while the latter indices are constructed of funds that are either open or closed.

By the time an index provider has dissected the universe of hedge funds that exist in a given database, which itself is already a subset of the 'actual' universe, and constructed indices according to its own criteria, the investor is left with a condensed view providing a fragmented view of the industry.

Hedge fund database biases lead to performance deviations

In addition to this condensed view imposed by a database and formulated by the index provider, there is a wealth of research that has categorised a number of biases that are intrinsic to the construction of indices. These biases militate against an accurate representation of hedge fund strategies and consequently may distort the relevance of a performance reference. Some biases inflate performance while others may skew index performance downwards, hence potentially only providing a biased estimate of the 'true' hedge fund universe.

As managers voluntarily report to selected hedge fund databases, a bias, known as self-selection bias, occurs. Voluntary reporting is driven by incentives. A manager may opt not to report its performances due to either a bad track record, creating an upward bias in the index, or because a fund with good performance is closed and wishes to retain its secrecy, leading to a downward bias. Managers understandably prefer to report good track

records. A 1999 study suggested that self-selection bias causes a performance deviation of 1.9% annually.

Also known as 'backfill' or 'retroactivity bias', instant history bias refers to the historical restatement of the index following the addition of a fund. Instant history bias may occur in two instances. First, the problem arises when a database rebalances the historical returns of an index every time a new fund is added. Second, instant history bias often occurs when an index is launched. For example, if a new index is launched today, it can decide to backfill returns since 2000, selecting only funds that have a suitable track record, instantly disregarding a segment of the universe that has a shorter track record. In both cases, inclusion of funds with good track records leads to overestimating the industry's performance, while those with a bad track record or extinguished funds are not reported.

When constituents are removed from an index, a 'survivorship bias', also called 'liquidation bias', occurs. This causes the index to show an upward bias due to obsolete funds or 'blow-ups' ceasing to report to a database. In addition, as private placements, hedge funds may also choose to stop reporting funds which have recently closed to new investors. This would result in a downward bias. Database biases may also be aggravated by a manager's selective choice of the share class to report. For example, the share class reported may not be open to all qualified investors, or the performance reported may not include 'side-pockets'¹.

Performance dispersion of hedge fund indices

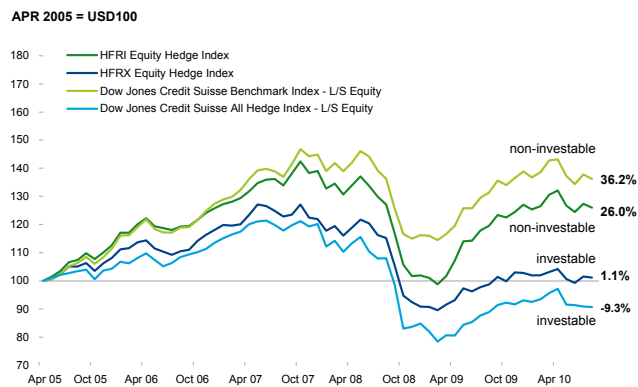
Returns of hedge fund indices can be highly dispersed owing to the varying selection criteria they use. Moreover, the cumulative performances of an investable and a non-investable index, for the same strategy and from the same provider, are likely to differ significantly. The performance chart below shows that, since April 2005, the Dow Jones Credit Suisse All Hedge Index—L/S Equity (investable) and the Dow Jones Credit Suisse Benchmark Index—L/S Equity (non-investable) have a cumulative return of +36.2% and -9.3%, respectively: a dispersion of over 45%! The performance between two providers publishing indices on the same strategy also shows considerable dispersion. Over the same period,

1 Hedge funds with a proportion of potentially or actually illiquid assets may separate those assets into 'side-pockets' (subject to restrictive redemption conditions) which allow investors to raise cash by redemptions against the liquid portion of the fund's portfolio.



the HFRI Equity Hedge Index (non-investable) and Dow Jones Credit Suisse Benchmark Index—L/S Equity (non-investable) show a difference of over 10%.

Hedge fund index dispersion



Source: Bloomberg; Pictet Alternative Investments

Do Fund of Hedge Fund indices provide a better representation of the hedge fund universe?

Fund of Hedge Fund (FoHF) indices are constructed using FoHFs that have decided to report to databases. In comparison to hedge fund indices, FoHF indices include direct representation of hedge fund share classes that may not otherwise be reported. This reduces a database's self-selection bias. Furthermore, when an underlying hedge fund is liquidated, blows up or sets up side-pockets, the investing FoHF does not restate historical performance. All these factors contribute to a better representation of the hedge fund industry, while also limiting the database biases described above.

Nevertheless, FoHF indices still contain biases of their own. A FoHF typically undertakes thorough due diligence and would therefore invest in top-performing hedge funds, avoid strategies that demonstrate high liquidity risks and exclude funds exposed to pitfalls. Furthermore, the hedge funds in which FoHFs invest include tactical cash allocations, whereas hedge fund indices are typically 100% fully invested. Unlike a direct hedge fund investment, investments in FoHFs incur a double layer of fees which dilutes performance. FoHF indices also suffer from self-selection bias. In addition, FoHF indices exhibit a wide dispersion between providers.

Conclusion: which index should be used?

In theory, to monitor the global performance of the hedge fund universe or when undertaking an optimal portfolio allocation study, FoHF indices, either composites or strategy indices, are the most reliable. However, in practice, many investors gravitate towards the Dow Jones Credit Suisse and HFR hedge fund indices. Using these must come with an understanding of the biases discussed above.

To benchmark FoHF performance, multi-strategy FoHF indices offer the most relevant reference. In terms of benchmarking a thematic FoHF, single strategy FoHF indices are most suitable. Dispersion is reduced when comparing FoHF indices with a diversified hedge fund portfolio of concentrated investments. Selecting the most appropriate index with which to compare a FoHF depends on the profile of the underlying funds.



As a final word, understanding that major differences exist across hedge fund indices is fundamental to an investor who wishes to be able to benchmark the performance of an individual hedge fund or a FoHF against the industry as a whole. And when an investor wishes to estimate the performance of the hedge fund industry, understanding that this differential exists across hedge fund indices and FoHF indices is also fundamental.

Pictet Alternative Investments and the Pictet group

Pictet Alternative Investments (PAI) is a division of the Pictet group responsible for investments in hedge funds, private equity funds and real estate funds. Over the last 20 years, PAI has developed key investment principles and rules based on best industry practice and solid experience, which today lie at the heart of its investment philosophy.

Founded in 1805 in Geneva, Pictet is a leading asset manager in Europe for both private and institutional investors. At 31 December 2010, assets under management and in custody totalled around USD 399 billion (CHF 372 billion; EUR 297 billion). Pictet employs over 3,000 people worldwide, including 600 investment professionals, analysts, economists and strategists.

Selecting the most appropriate index to compare a FoHF with depends on the profile of the underlying funds.



Impact investing

A new asset class or just another hype?¹

Uli Grabenwarter

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Impact investing nowadays appears to be omnipresent in the debates on financial markets. It reflects a new trend of thought: next to generating financial wealth, the investment industry has increasingly to consider its impact on the sustainability of our society.

Most recently, with the beginning of the financial crisis in 2007 which led to the biggest global economic crisis since the big recession in 1929, the question arose whether the exclusive focus on financial and often short-term measures of investment performance is suitable to expressing all dimensions that investors seek to have reflected in their investment choices.

Undeniably,

- the increasing pressure to integrate into the business models of corporations the cost of externalities that so far have been considered as free
- the scarceness of natural resources and its impact on the growth of our economies

¹ This article is based on thoughts developed in the context of the research report "In search of gamma- an unconventional perspective on impact investing" co-authored by Uli Grabenwarter and Heinrich Liechtenstein and published in May 2011.

- and last but not least, the shift of consumer behaviour towards products and services offered by firms that comply with an ethical conduct of business

have also challenged the asset management industry to respond to a new type of demand from their clients.

As a result, company managers started to realise that non-financial aspects of their business performance were becoming an increasingly important factor in the value expectations of their investors and their customer base. Aspects that have so far been soft factors in business decisions suddenly became financial return drivers and hence conquer territory that has so far been dominated exclusively by short-term profitability ratios.

From the investment industry initial responses to this trend included several types of screening processes in the quoted investment space and eventually led to the emergence of sustainability indices comprising companies that had undertaken efforts to reduce the negative impact of their business on society. Admittedly, this did not reflect a very ambitious impact investing approach. Frequently the efforts of companies to be included in such sustainability indices merely served image campaign purposes.

As long as the impact investing debate was confined to the public markets space it benefited from two major simplifications:

- 1) In the absence of any real power of individual shareholders in a quoted company (given the small stake typically held), the relatively simple concept of screening processes applied by asset managers was deemed sufficient to justify the impact dimension of an investment. This provided for a fairly low threshold for companies to be considered as 'impact investing' targets
- 2) The trade-off debate between social/environmental impact and financial return did not even arise since 'socially responsible' businesses were merely a subsection of the quoted markets. Hence, the objective of financial return maximisation for each of these companies was never in doubt

With the disastrous impact of the financial crisis in 2007/2008 on the wealth of investors and the balance sheets of financial institutions, the debate on value creation in the investment industry was carried into all market segments, including the private equity industry and other rather illiquid and unregulated asset classes.

As the ambitions in impact objectives expressed by investors grew both in quantity and quality, financial markets were forced into a debate to define more clearly what impact investing means and how it can differentiate itself from other mainstream markets.

But even the consensus that impact investing needed to be (i) for profit and (ii) have an intended measurable social/environmental impact at the core of its investment thesis could not calm the debate. The industry continues to struggle with two main questions:

- 1) Does social impact come at the cost of financial return, or can Impact Businesses achieve market returns?
- 2) How can impact be measured and made part of an investment decision process?

However, when analysing the core concerns addressed by these questions more closely, it becomes clear that the main issues at stake, although not irrelevant for the finance industry, are far from being confined to impact investing.

The trade-off debate:

The frequently raised doubt as to whether impact investing can achieve 'market return' is a widespread attitude based on the belief that investors need to make a 'trade-off' between financial profitability and social or environmental impact: it suggests that social impact is always at the expense of financial return or in other words, it is 'bought' at the expense of financial return.

This concern appears to have its origin in a fundamental mistake in the very definition of impact investing. Whilst it is undeniable that impact investing needs to be for profit (or it would not be an 'investment') and has to intentionally address an impact objective (or the impact would only be a coincidental side effect that was not part of the investment thesis) these two aspects are both necessary but not sufficient conditions to define impact investing.

It is equally vital for the definition of an impact investment that the financial return drivers of the funded business models cannot be dissociated from the impact objectives. If the business model is the means to achieve the impact objective, there has to be by definition a positive correlation between the impact objectives and the business model's financial return. Any business model where every unit of social/environmental impact has a cost in terms of financial return is hence inevitably a disguised form of philanthropy.

Once the correlation between impact objectives and financial return drivers is accepted as part of the business model, the assumption of a 'trade-off' becomes counterintuitive, not least if examined against the very understanding of the term 'market return' in other asset classes.

The term 'market return' is prominently used in the Capital Asset Pricing Model (CAPM) and reflects the return generated by the market portfolio of investments, of which a contemplated investment is part. The notion of market return implies the existence of a market for the type of envisaged investment. The assumption of the existence of a homogeneous market portfolio of assets with comparable risk/return features shared by all investors is a major simplification that is unlikely to withstand the reality check even in quoted markets. Consequently, it becomes even more remote for asset classes that are illiquid or not tradable at all.

However, any illiquid asset class that has challenges in defining comparable market returns will have equal difficulties in assessing an individual investment against such market return. This observation underlines that, at least in illiquid asset classes, there is no concept of market return and ultimately there is only a choice driven by investor preferences, which combine the purpose of the investment with its financial profitability and the risk profile associated with the underlying business model.

If the argument of trade-off between financial return and non-financial investment objectives were to be maintained, it would also have to be applied with the same consistency at least to all those asset classes that are lacking a liquid market and hence lack comparables of a 'market return'. Yet, financial investors appear more 'forgiving' when it comes to the justification

of investment decisions outside the impact investing space. This phenomenon is presumably triggered by the ambition of impact investing to justify the investment case as a whole, while other asset classes limit themselves very often to a financial return promise, which frequently remains just a promise.

Impact metrics- the key to defining an industry identity:

Much more challenging appears the second core question faced by the impact investing industry: how to measure impact and make it a meaningful component in the investment process?

By definition, any investment in a business has a social and/or environmental impact, otherwise it would be fairly difficult to find a marketing strategy for such a company's product or service offering.

However, if it is true that virtually every investment has a social and environmental impact the only difference there is between impact investing and traditional investing has to lie in the measurability of the non-financial impact.

If impact investing, to date, has not made it to a genuine asset class it is primarily because it has failed to define its industry standards, and impact metrics are these standards' centre of gravity.

The main challenge of impact metrics is to make them a suitable tool for the various stakeholders in an investment process. These stakeholders include a great variety of constituencies ranging from employees, to management, to customers and finally to the most obvious constituency of investors in the form of shareholders or debt providers. If a business has an impact component at the core of its business model, each of these constituencies of stakeholders has a specific expectations in terms of information provided through impact indicators and metrics.

Defining meaningful impact indicators at the level of a businesses is in itself challenging. It is of utmost importance to ascertain that such indicators are truly representative for the impact component in the business model.



Virtually, every investment has a social and environmental impact. Hence, the only difference there is between Impact Investing and traditional investing has to lie in the measurability of non-financial impact.

Indicators at the level of the business model serve the purpose of tracking the impact of the company's activity. Such impact indicators can and actually must be very individualised and specific to the company's business model or they lose their information value.

Here, the use of impact metrics to date has frequently been impaired a major mistake: for the sake of comparability impact indicators at business plan level (e.g. the tons of a certain plastic substance that previously could not be recycled and now can be due to a new technology) are translated into general indicators (e.g. the amount of CO₂ saved by not incinerating these tons of plastic) to be compared to other investments and aggregated at portfolio level. The question as to whether or not the CO₂ footprint expresses the genuine social/ environmental impact remains unanswered (perhaps, the CO₂ footprint resulting from the incineration of this substance was not the biggest issue, perhaps it was dioxin gases which in tiny quantities presented a much bigger threat). Equally missing in such an indicator is the impact of the solution found in terms of scale of the issue to be solved (how many tons of this plastic material can be treated in this alternative recycling procedure and can it and will it be applied at scale?). All these questions are sacrificed for the sake of comparability and aggregation of impact indicators at portfolio level.

And here precisely is the dilemma of impact indicators that have so far been tested in the impact investing space. The abstraction made in the information provided by impact indicators for the sake of serving the INVESTMENT performance analysis of impact investors sacrifices their value as measures for IMPACT performance. Paradoxically, the resulting compromise does not serve any of the parties:

- i) For running the underlying business, such aggregated indicators have become meaningless: how is the entrepreneur of the plastic recycling facility going to derive any useful information for the conduct of his business from the reduction of his global CO₂ footprint?
- ii) For the investor who has been investing in the recycling business through a fund or a fund-of-funds manager, the information is hardly any more valuable: what does it mean if a business model has managed to save a few hundred thousand tons of CO₂? At what cost? And is it really relevant which of two asset managers has saved more tons in CO₂ in absolute values? Is it not more a question of which asset manager has used the capital more efficiently to address a societal or environmental issue?

If this dilemma is to be overcome, an approach to impact metrics ought to accept that IMPACT performance indicators and impact INVESTMENT performance indicators serve two different purposes that cannot be made compatible in one measure. However, IMPACT performance indicators can serve as input factors for the impact INVESTMENT performance indicators.

The research report '*In search of gamma – an unconventional perspective on Impact Investing*' proposes a model for an integrated measure for financial and impact investing performance at portfolio level. The presented gamma factor provides for an impact INVESTMENT performance measure which offers the freedom to produce meaningful KPIs at the level of individual business models. The basic idea of the concept is to divide impact metrics into a two-layer approach, of which

- a) one layer expresses the impact objectives at investment level in indicators (KPIs) that can be freely defined and tailored to a specific investment's needs and features and
- b) a second layer assesses and expresses an investment manager's or asset managers performance in terms of an 'impact-adjusted return'.

The gamma factor is proposed as an extension to the Capital Asset Pricing Model (the CAPM) which serves the purpose of determining the expected return of a given

investment under the assumption of a given risk profile compared to a market portfolio.

With the help of the gamma factor, the expected financial return r_{ai} for an investment derived from the CAPM

$$r_{ai} = r_f + \beta^*(r_m - r_f)$$

where r_f is the riskfree return rate and r_m is the market return for the underlying asset can be translated into an impact-adjusted return. At realisation the expected return on an investment r_{ai} becomes the realised return on an investment r_{ei} . In applying the gamma factor this return can be translated in a Impact Adjusted Return r_{IA} as follows:

$$r_{IA} = r_{ei} * \chi_s$$

where r_{ei} is the eventually realised return on an investment and χ_s is the standardised gamma and expresses the impact achieved as a ratio of the overall impact level observed at a given point in time post investment over the impact level set at base 100 at the time of investment.

The resulting multiplier, which

- a) is superior to 1 if the set impact objective is exceeded
- b) equals 1 if the set impact objective is met
- c) is inferior to 1 if the investment falls short of its impact objective

is then applied to the expected (and later observed) financial return of the investment in order to derive the impact adjusted (expected/realised) return.

The benefit of this measure is that it dissociates the impact quantification at the individual investment level from the impact performance assessment at portfolio level or at the fund manager's track record level.

It has the advantage of allowing for an individualised definition of impact KPIs at investment level without compromising on the comparability of impact performance at the investment management level.

As such, both requirements on impact measures, i.e. their comparability and their meaningfulness for the impact objective pursued, can be satisfied without compromising on either of them.

The challenge that remains is in the degree of sophistication and ambition reflected in the impact KPIs at individual investment level. Theoretically, an asset manager or impact investor could set easy-to-achieve impact targets in order to boost its impact performance. Such behaviour would have to be detected in a due diligence process on such investment manager by analysing its (impact) investing track record. While this may seem like an additional effort to undertake by investors, it is no different to a due diligence requirement for making an informed investment decision e.g. for a private equity fund investment.

It also appears far easier to submit the quality of impact objectives set by an investment or asset manager to an objective rating exercise than to achieve comparability of impact KPIs at the level of individual transactions that have no features whatsoever in common.



Regulatory reform: Winners and losers in the asset management space

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While the European financial services sector has faced significant regulatory change over the past decade, the pace of change has accelerated rapidly in recent years. The events of the financial crisis have triggered a wave of new regulation worldwide that is set to have a significant impact on the environment in which asset managers operate.

Before the financial crisis, regulators were largely focused on enhancing market efficiency, through initiatives such as MiFID (Markets in Financial Instruments Directive) and the evolving framework for UCITS (Undertakings for Collective Investment in Transferable Securities). In the wake of the crisis, however, the focus of regulatory efforts has shifted. Today, the emphasis is firmly on addressing systemic vulnerabilities, improving market transparency and enhancing investor protection. Asset managers are increasing the focus of regulatory reform, through initiatives such as the Alternative Investment Fund Managers Directive (AIFMD) and UCITS V.

A raft of regulation is in the pipeline, as discussed in our recent thought leadership paper, *'The Changing Shape of European Investment Management—Regulatory Change'*¹. Basel III and Solvency II are set to address capital adequacy and risk management in the banking

and insurance sectors. The AIFMD and the European Market Infrastructures Regulation (EMIR) will introduce new regimes for alternative funds and over-the-counter (OTC) derivatives, respectively.

Several regulatory initiatives, including the MiFID II review, UCITS V, the EC's review of package retail investment products (PRIPs) and the review of the Investor Compensation Scheme Directive (ICSD), have implications for the market in retail investment products. Meanwhile, depositaries and custodians are subject to changes in their responsibilities and legal liability, although the exact framework will depend on the final outcome of the legislative and rule-making process. Regulators also have remuneration in their sights, with efforts towards more clearly aligning the compensation of individuals in key risk-taking and supervisory roles with the long-term performance of their businesses, across the financial industry.

¹ See www.statestreet.com/vision





Challenges for asset managers

While increasing investor protection and enhancing risk management practices are important goals, these measures are likely to increase complexity, in terms of reporting, and cost. They are also likely to have a fundamental impact on how investment products are marketed and sold. Asset managers may need to undertake a root-and-branch assessment of their current approach, extending from their operating model to their product range and target investors.

These changes are happening against the backdrop of broader, secular pressures on the industry. The 'pension gap' is becoming an increasingly acute problem. With an ageing demographic and the shift from Defined Benefit (DB) to Defined Contribution (DC) pension schemes, individuals are bearing more of the investment risk of funding their extended retirements. Solid investment returns will become more critical than ever to plug the gap.

There are many outstanding questions: will outperformance be harder to achieve amid increased regulatory complexity and cost against a backdrop of only moderate economic growth expectations? How can asset managers square this dilemma? Does this environment create opportunities for asset managers that are agile and innovative in the face of significant regulatory intervention? What is certain is that the industry will experience significant evolution, at least in the short to medium term, amid continued and rapid regulatory change.

Issues of trust

The depth and duration of the financial crisis have left a lingering impression on investors' attitudes toward risk and, in some cases, undermined their trust in financial markets. Tightening regulation is an important factor in restoring that trust. For asset managers, there is competitive advantage to be gained by responding quickly, comprehensively and inventively to the emerging regulatory environment. Early movers in understanding and adapting to new regulation, and in demonstrating their efforts to clients, may prove to be the winners.

The speed of change is a particular challenge, even for those individuals whose job it is to monitor regulatory developments. Successful firms will be keen to demonstrate to existing and potential clients that they are knowledgeable about, and ready to adopt, the full range of forthcoming initiatives as they are introduced in the coming months and years.

While the AIFMD and other initiatives will add cost and complexity, these are not the only challenges that asset managers may experience. As banking regulation begins to exert a greater influence on the asset management industry, managers may face regulatory frameworks that do not always take sufficient account of the specific needs and characteristics of their sector.

Succeeding under such pressures will require careful strategic and operational planning. Managers with significant product differentiation and expertise, that can skilfully adapt their strategic direction to the new

environment, have an opportunity to increase market share. Other managers may target the trend towards low-cost index exposure, whereby investors allocate a significant proportion of their assets to passive managers. Either way, the highest-quality systems, controls, marketing and execution will be essential.

Whether or not an asset manager chooses to retain non-core functions in-house or seek outsourced solutions may come down to whether they have the scale to accomplish these tasks cost effectively themselves. Certainly for the smaller managers, the required ongoing cost will be significant. The increased reporting demanded by both regulators and investors will require year-on-year investment in technology systems as well as employee training and development.

Drive to outsourcing

Some of these costs can be eliminated by choosing outsourced solutions. Investors and regulators are demanding more information, greater insight into underlying fund investments and reports in a variety of formats. External service providers may be better placed to meet such demands as they have the necessary scale and technical resources to deliver what is required. This is an opportunity for external providers to guide and assist clients through the significant regulatory and investor-driven change that confronts them. Asset managers will be looking for servicing solutions that are consistent across jurisdictions and that can successfully navigate the regulatory complexity at both a regional and local market level. Already, in anticipation of the AIFMD, we are seeing heightened interest in independent valuation services.

Experience gained by investment servicing providers from delivering such services to the asset management community will help ensure that clients benefit from best practices. Moreover, the economies of scale that support continuous investment in technology and expertise can ensure that clients achieve best pricing of compliance cost. That said, key issues for service providers are the degree of liability they may need to assume on behalf of their clients and the implications in terms of cost and risk management.

Question of scale

Some smaller, entrepreneurial asset managers may decide to join larger groups, a tactic that enables them to concentrate on their core skills while relying on the larger organisation to support their increased regulatory and administrative requirements. This trend is already evident in the alternatives space. The challenge will be retaining a distinctive culture and approach when part of a bigger group. There will always be a place for smaller, more agile businesses to remain independent, especially where they can harness external service providers to enable them to concentrate on their core fund management capabilities. The challenge for asset managers of all sizes will be to stay focused on their core DNA, i.e. building successful investment portfolios, when it is easy to be distracted by the volume of emerging regulation.

Evolving product proposition

Regulation is likely to have a major impact on future product development, and product developers will need to collaborate closely with their risk and compliance teams at speed, to ensure that new products are compliant, workable and first to market. In this context, initiatives such as the Key Investor Information Document (KIID) and PRIIPs are driving greater transparency, with the aim of enhancing investors' understanding of product and pre-contractual information².

Successful firms will be keen to demonstrate to existing and potential clients that they are knowledgeable about, and ready to adopt, the full range of forthcoming initiatives as they are introduced in the coming months and years.

2 Initiatives to improve financial education at a broader level, through bodies such as the Consumer Financial Education Body (CFEB) in the UK, have an important role to play in terms of building consumers' trust in the financial services industry, although the benefits may take time to come through.



The marketing of alternative-style strategies under the UCITS brand, a trend that could be accelerated by the AIFMD, is serving to bring hedge fund-like vehicles to a greater audience. This does, in turn, raise the question of whether increased regulation will encourage asset managers to push more aggressively at the boundaries of what is allowable under frameworks such as UCITS. In the wake of the AIFMD, asset managers that currently offer both traditional and alternative strategies may consider reconfiguring their alternative products to be UCITS-compliant, so that their business is subject to only one regulatory regime, although this approach may have significant drawbacks.

In any event, asset managers will need to be highly cognisant of what kind of investor they are targeting. Initiatives such as the MiFID II review, which proposes the reclassification of products as 'complex' and 'non-complex', may mean that some UCITS products are classified as unsuitable for retail investors. As a result, managers may need to develop and target their products more narrowly at specific types of investor. In addition, there is speculation that regulators will seek to reclassify some institutional investors as retail investors, including local authorities, in an effort to give them greater protection.

Asset managers face regulatory action on a series of other fronts, with MiFID II, PRIps and the UK's Retail Distribution Review (RDR) seeking to eliminate any conflicts of interest that may exist where distributors are remunerated by sales commission from the product manufacturers. It adds up to a situation in which asset managers will have to rethink the marketing and distribution of investment products. When developing products, the regulatory constraints will increasingly need to be the starting point.

Overseas competition

The scale of the financial crisis has triggered collective action on the part of regulators globally. Their goal, which stems from post-crisis discussions on the future of the financial services sector at the G20 summits, is that there should be global regulation of equal strength. There should be high levels of cooperation and reciprocity among regulators around the globe, with no weak links. In practice, not every market will move to develop their regulatory regimes at the same pace, and there may be differences of interpretation. Effective regulatory arbitrage between countries is, at least in the short term, both a risk and an opportunity. Where markets can host asset management activities without the burden of regulation experienced in Europe, there is a risk that asset managers that feel they would benefit from such freedom may move their activities.



While regulation within Europe is likely to become more harmonised supported by the creation of the new European supervisory architecture globally there are likely to be more regional variations and nuances.

Meanwhile, the popularity of the UCITS platform among non-EU fund providers, and the large potential European market, suggest that those seeking to offer fund management services in EU markets will accept the regulatory burden as part of the price of entry. At the same time, the European asset management industry will be closely monitoring developments in Asia, where the idea of an Asian Funds Passport is gathering momentum and could create a regional fund vehicle to rival UCITS³.

Regulation and pension liabilities

The financial crisis has crystallised some of the challenges facing European pensions. The EC's July 2010 green paper 'Towards adequate, sustainable and safe European pension systems' notes that the financial crisis "*aggravated and amplified*" the impact of the trend in demographic ageing and calls for efforts to "*improve the efficiency and safety*" of pension schemes⁴. One suggestion is that European regulatory efforts or a code of good practice could help member states achieve a better balance for pension savers and providers among risks, security and affordability.

Against the backdrop of extended retirements and the relentless shift from DB to DC, the desire for less risk and greater reward is a difficult circle to square, particularly while European governments' credit standings are challenged and interest rates remain at historic lows. In many ways, the crisis has brought the dilemma for regulators into sharp relief: at what point does regulation designed to improve transparency and security for pension savers actually make the industry less agile and more cost heavy?

Issues like these will take some time to play out, and raise questions over what the regulatory environment will look like five to ten years out. For the time being, asset managers need to focus on understanding and navigating the new regulatory environment. Preparation is everything. Even though uncertainties remain, the road signs are in place and there is no time to lose.

³ For more on this topic, see State Street's Vision Focus paper, "Asian Funds Passport to Growth," December 2010.

⁴ "Towards adequate, sustainable and safe European pension systems," European Commission green paper, July 2010



Hidden challenges of KII

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In 2009, the European UCITS IV Directive was adopted at a somewhat accelerated pace compared to the same process for UCITS III. European asset managers then focussed straight away on the apparent opportunities offered by the new regulation and the promised land of economies of scale and cost savings.

Master-feeder structures and cross-border fund mergers stole most of the limelight. Prominent fund domiciles engaged in rampant speculation as to what the borderless management company landscape might mean for them. The announced disappearance of the (not so) simplified prospectus in favour of the Key Investor Information document ('KII') just received a nod of approbation, if only for the tacit recognition of the former's failure to meet its intended target: to be simple.

And yet, while master-feeders, management company domiciliations, etc. are still at the reflection stage, for a few months now, the KII has been the hot topic in

conferences, press articles and business discussions.

The reason is simply because most feel dazzled when looking at the task and at numbers. Not those numbers relating to potential savings thanks to master-feeders and cross-border rationalisation of fund ranges. Tax and legal impetus and uncertainties have relegated once much-hoped-for novelties, including the management company passport, to the backstage.

The number of KIIs to be produced, translated and approved is impressive (about 300,000 across Europe). The implementation time bomb is ticking, and at last dawning on asset managers and fund promoters alike.

At first glance, European asset managers considered the KII to be just another type of fund factsheet or newsletter, distributed by email to investors and prospects and disseminated around the globe. But the KII is much more than that. This contribution will seek to shed light on a few of the 'submerged' implications of this 'simple document', some of which are still only fully emerging.

The very first challenge to meet is the choice between in-house production and outsourcing. Initially, most solutions showed to potential customers were limited to a copy of the illustration provided by CESR, (Committee of European Securities Regulators). CESR serves as a forum for EU regulators to negotiate with practitioners and decide on what politicians have left for them to consider in the European legislative arsenal. Now rebranded as the European Securities and Markets Authority (ESMA), CESR has been invited to tackle issues as diverse as recognition rules of rating agencies (under the spotlight since the market meltdown in 2007/08), IFRS standards for financial institutions or remuneration policies in the financial sector, yet another hot topic from the years 2007/08.

Fund promoters today can choose from a reasonable range of KII solution providers. All have completed their technical development. All are impatient to demonstrate their real-life ability to aggregate millions of data elements from multiple sources into a single double-sided A4 document.

There is unfortunately always a 'but'. With the KII, the 'but' lies in the complexity of the data required to compute some of the indicators that regulators have made compulsory in the document. Nothing can be added to what is prescribed by the UCITS IV Directive and Regulation (EU) no. 583/2010, published less than a year ahead of the first transitions.

For example, the Synthetic Risk and Reward Indicator (SRRI), a measure of the fund's volatility over the last five years. This is the simplest case, where the fund in question is classified as a 'market fund'. Not that simple indeed, as it requires the computation of weekly performance figures over the last five years—

performance from Monday to Monday, or from Friday to Friday? What about legal holidays? Consider the case of a newly launched fund, where the required five-year track record is not available: simulate the net asset value (not a proforma performance empty of fees) for the prescribed period, compute the 260 required weekly performance figures and then derive from that data series the SRRI. Quite simple if you are a quant; not if you are a traditional asset manager. And would the SRRI realistically and validly provide information about the fund's (potential) risk and reward profile? The jury is still out on this key question. As an example, and by virtue of the nature and methodology of the SRRI, it is highly probable that those who have precisely so thoroughly vilified since 2008 would have published rather low SRRI levels prior to the crisis.

As another example, the on-going charge calculation is not congruent with currently produced total expense ratios. It includes performance fees or other conditional charges. This may give rise to an on-going charge figure that is higher than a capped TER where such a cap is in place another complexity to monitor, and potentially to explain.

Technology is essential in the management of the data flows necessary to compute the two figures required by the KII. This for two reasons: the sheer amount of data necessary across fund ranges and the swiftness in the update required, both at calendar year-end and further (or prior) to any significant change in the characteristics of a fund. Technology is equally essential in forewarning the fund's governing entities of a potential change in the SRRI classification which would require the issuance of an updated KII.

But the KII also requires technology for other purposes. First, promoters and fund management companies must ensure dissemination of KII updates across their entire distribution networks at the same time. This means that every single link in the distribution chain must receive the update at the very same moment as its peers. This cannot be achieved by traditional communication channels, dependent upon the willingness and readiness of the reader to acknowledge receipt of the information that was disseminated. Second, and more importantly,

the management company has a fiduciary obligation to ensure KII receipt by a potential investor at the time of her or his request for information. Regulations are not very succinct on the KII availability at the point of subscription, or sale. It must however be in the investor's hands sufficiently early to allow for an informed investment decision.

Regulations are conversely quite extensive on what needs to be disclosed in the KII, about how, and about what not to write. The KII includes two 'narrative' sections. These deal with the fund's objectives and investment policy, and with risk disclosures relating to those not adequately captured by SRRIs discussed above. Ultimately, the latter section tackles all risks which are not directly or indirectly reflected in the fund's investments' valuation.

street. By default, if the latter understands, the former also would. Checking each single word used in the KII is quite simple with a good dictionary, but requires time and skills to overcome the obstacle.

Writing expertise starts from the point where complexity comes into the picture, together with judgment and assessment. Not only should the KII writer(s) know by heart the almost 30 pages of detailed guidance relating to this two-page document, but they must also demonstrate a rare ability to transpose the complexity of investments into plain language without altering their behaviour, characteristics and potential risks.

Unfortunately, plain language is not defined by law or by regulation. Simple examples can lead to lengthy discussions when it comes to transposition into the asset management realm. Providing the right amount of information to potential investors and adopting the right level of simplification can prove a true challenge when assessing compliance and legal implications of an (over)simplified overlay. Here too, the writer needs to demonstrate extensive 360° asset management practical experience. If not, the resulting text might not find the right mix between consistency with the prospectus, representations made in marketing material and the very low level of average investors' financial literacy. Just try to explain a futures contract without using any financial or legalistic word.

The challenges ahead are less to gather a project team to manage the whole than to apply plain language principles for the first time in the European asset management's history!

Until very recently, most considered plain language as an obviously simple style exercise. It is not just quite that. It requires particular skills and uncommon financial literacy to transpose the jargon commonly understood by us all into plain English. Simple, concise sentences capped to a maximum number of words (at least in English), using only those words likely to be understood by our least sophisticated investor and that do not have another meaning in street language is tricky to achieve. Although the UCITS IV Directive and final CESR guidance propose using a language that can be understood by the average retail investor, and provided you know exactly what such investor means for your organisation, previous versions suggested understanding by the layman, the man in the

The KII is meant to describe what a particular fund actually invests in, and how its managers select and monitor investments on an on-going basis. The document is by no means meant to disclose all possibilities offered by its by-laws, as the French regulator stated in its recent recommendation-position. The KII writer must therefore be able to decrypt the fund's latest periodic reports to investors. On top of that, the KII writer must be able to assess the potential impact of some instruments and techniques on the fund's performance. There are many different ways to consider the impact of derivatives: by reference to their weight in the fund's assets, by reference to the relative



importance of their maximum potential loss (stress-testing); by reference to the impact of their realised, and unrealised, profits/losses on the average net asset value; etc. In a non-sophisticated UCITS, options for 0.01% of the assets may very well add or cost 1% to the fund's performance. Per se, not a dramatic figure, except when the fund's performance stands at around 3 to 5% over the last few years.

For all these assessments and judgments, the continuous dialogue between the fund conducting officers and the KII writer is the keystone when it comes to making decisions on what to disclose, and to what extent. As in any large project, the KII impulse must come from the top of the organisation, which remains responsible for making it happen, whatever happens. Top management is also accountable by the UCITS IV Directive for providing investors with accurate, not misleading, and consistent information that the average investor readily understands at first reading. This reads as providing investors with information that is up-to-date and current in terms of objectives and investment policy, risks narratives and instruments used to reach those objectives.

In the face of the above complexities, it is increasingly apparent that the KII represents a challenge for its initial implementation, and for its future maintenance. The initial attention given to the explanatory texts and to the required computations must be maintained throughout the life of the fund. This calls for judgment and continuous compliance with the provisions set out, taking note that the preparation of one single KII requires a full diligence of the related fund. It also requires access to non-public information and data, such as detailed valuation rules, risk management policies and internal procedures.

In addition to the technical complexities in the first flush of enthusiasm, permanent monitoring requires attention and resources. Asset managers will continue to manage their funds as in the past. From now on, they need to take the implications of the KII into account at every single step of their day-to-day business: from product

design to actual investment decision. Few promoters can afford the luxury of having a person or a team of sufficient seniority, authority and knowledge to take care of driving the KII process safely through all these inherent pitfalls.

And this is where there is a primordial role to be played by competent and independent service providers able to demonstrate the requisite expertise, knowledge and track record of delivery.

The KII has yet another characteristic that is largely overlooked, especially when assimilated to a factsheet. It is a legally pre-contractual document, conceived as a pillar of modern investor protection. It will find continuity in UCITS V of which the main thrust is clearly intended to be investor protection.

The next crisis will occur, sooner or later. It is just a matter of uncertainty about when and where. Unhappy investors will then undoubtedly look at the KII and challenge it in front of the courts. Judges are no financial professionals and that they will take the standpoint of the average non-financially-literate investor to form their opinion. Recent evidence of this can be found in a judge's explanation of his decision in a very recent case in front of the German Supreme Court. A bank was condemned for failing to adequately disclose to an institutional investor the risks inherent in a spread ladder swap. And the judge commented: *"Just because I can read a poem does not mean I have understood it."*

When that day comes, the only winners will be those who can demonstrate that they have consistently applied, from the very beginning, the care and diligence required by the UCITS IV implementing measures.

Investing now in the best professional assistance in relation to the KII seems a small price to pay for that quality assurance. It also demonstrates a commitment to serve the best interests of investors to the highest standards of prudence and good faith.

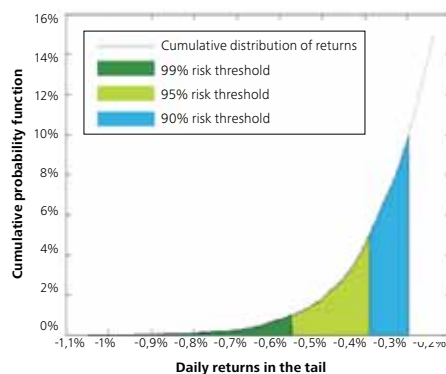


Towards the outsourcing of risk reporting

In the aftermath of the liquidity crisis of 2007-2008, a number of indications have pointed out to the failure of risk management and its relative inability to provide insightful information when it is needed the most. An increasing number of observers even agree to say that financial crises and economic recessions also find their roots in the failure of risk measurement systems.

To have risks managed, they first need to be accurately measured. For this reason, European regulatory text on this subject will be amended and extended to a more comprehensive and quantitative risk coverage. This shall follow the CESR's initiative to issue level 3 guidelines in relation with risk measurement¹, which are in the process to be transposed into a local circular to come into force for 1st July 2011. As a major evolution, risk models will have to be properly validated by a party independent of its building process, and liquidity risk must be measured and reported.

Tail-analysis :
probability distribution of portfolio return for 1 day



In this context, Deloitte's Capital Markets team took the necessary steps to set up a fully fledged risk measurement and reporting solution with the following features:

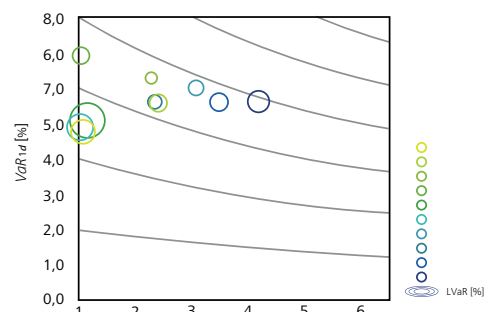
- Compliance with forthcoming legislation
- State-of-the-art risk measurement models to provide accurate insights and professional value
- Responsiveness of risk measurement systems, adapting rapidly to crisis conditions
- Advanced mapping and comprehensive coverage of financial instruments

- Modularity of the solution and tailor-made risk reporting
- Further dimensions incorporated: liquidity risk, style analysis and additional nice-to-have features

Deloitte's Capital Markets team, describes the philosophy of the new risk measurement solution as follows:

"Risk managers hardly ever analyze reporting results since they spend most of their time struggling for producing the figures. Our solution intends to fill this gap, by providing a pragmatic, scientific and transparent integrated reporting tool, which helps decisions. It offers risk managers a facility to effectively communicate with top management. We deem this interaction to be at the heart of the function of risk management."

LVaR (most/least risky positions)



Leveraging on its expert knowledge in the regulatory environment for investment funds, and on its comprehensive practical experience acquired from reviewing risk management systems in Europe's leading investment fund centre, Deloitte is in a competitive position to provide a new generation of risk measurement systems for investment funds. This is possible essentially because Deloitte can actively anchor its development around a multi-disciplinary team consisting both of compliance experts, quantitative risk modellers and IT specialists.

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¹ CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, CESR 10-788.

New notice issued by IRS on FATCA

On 8 April the IRS issued Notice 2011-34, which completes and replaces in part Notice 2010-60 by providing additional information on the FATCA implementation process.

The new Notice provides details on the account identification rules, the certification that should be signed by the compliance officer in respect to the controls made by the FFI, including a confirmation that the FFI should not assist or encourage a U.S. person to avoid FATCA rules. It also includes specific points regarding the fund industry, e.g. new definitions of deemed-compliant FFI and pass through payment and finally U.S. account reporting details.

This new legislation will help the financial market start the FATCA implementation process.

SEC expects to extend private fund adviser registration deadline - Charting a new course

The Securities and Exchange Commission (SEC) expects to give a grace period until the first quarter of 2012 to investment advisers to private funds that are required to register under the Dodd-Frank Act. Dodd-Frank, which came into effect in July 2010, requires private fund advisers, including those that advise hedge funds and private equity funds, with at least \$150 million in assets in the U.S., to register with the SEC by 21 July 2011.

However, in a letter dated 8 April 2011, to the President of the North American Securities Administrators Association Inc., SEC Associate Director, Robert Plaze said "*We expect that the Commission will consider extending the date until the first quarter of 2012.*"

While the SEC has proposed exemptions for family office advisers, venture capital advisers and foreign advisers, the SEC has yet to finalise these exemptions. The SEC staff statement indicated that the SEC will finalise these exemptions by 21 July 2011.

Link'n learn

Agenda

26-May - Introduction to real estate funds

09-Jun - Investment management accounting updates

16-Jun - Introduction to the Alternative Investment Funds Managers Directive (AIFMD)

30-Jun - Introduction to private equity funds

07-Jul - Introduction to collateralised debt obligations
Deloitte Link'n Learn – training programme
2011 3 / 33

14-Jul - Introduction to Islamic funds

15-Sep - Introduction to Solvency II

22-Sep - Introduction to ETFs and Index Tracker Funds

29-Sep - Investment Restrictions of Investment Funds

06-Oct - Riskmanagement for investment funds:
regulatory perspective

13-Oct - Introduction to FATCA

27-Oct - Impacts of Basel II and Solvency II
for the asset management

17-Nov - Performance fee and equalisation

24-Nov - Introduction to IFRS for funds

08-Dec - The renewable energy market

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To be covered in our next edition

- FATCA for investment funds
- Exchange of investor information
- Cross investment Funds

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