

Performance

A triannual topical digest for asset management professionals, issue 6, September 2011



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Added value brought to the asset management industry by cross sub-funds investment techniques

Asset management in a post-crisis environment – Reconsidering profitability

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

We welcome you to our sixth edition of Performance, Deloitte's global magazine with content from Investment Management practitioners and industry experts. Our globalised industry needs widely spread networks of professionals with adapted discussion forums. Deloitte decided more than one year ago to build an open asset management community where more than 30 Deloitte practices join forces with industry thought leaders. The results of this collaboration have been impressive. Performance is now read by close to 20,000 investment management personnel in more than 30 countries around the globe and we will continue to increase of our readers' base.

Over the last months, we have been confronted by a crisis never observed before in the globalised financial economy. Governments and markets had to come up with dedicated answers of a never experienced extent. We are keen on sharing economist's optimistic end scenarios of a full recovery, although, our industry is aware that the road is still long and steep. The investment related risk/reward ratio has known better times, however there are encouraging signs towards a considerable improvement for providers of uncorrelated returns at a reasonable price. Regarding conventional asset classes, flows are reasonable into established brands and inexpensive beta products, however asset gathering is facing strong headwinds. Fund performance is the key driver of our industry's growth and considering the rather flat yields and equity volatility, asset managers will need to enhance creative product design and liquidity to be distinctive in the marketplace.

Regulation is strongly driving an increase in investment transparency and investor protection, unfortunately often at the expense of fund performance and choice. While the industry will embrace the notion of a level playing field and jurisdictional neutrality, the operational impact and cost of change is significant and should not be underestimated to regain investor and regulatory favour.

As professionals, we are also very concerned about the ability for asset managers to propose appropriate investment solutions at a competitive price. Deloitte is actively participating in the thought leadership to define the shape the future of the investment management industry and is significantly involved in the regulatory debate to ensure the future is comprised of days to look forward to.

As usual, We hope you enjoy the current issue of Performance, and would like to thank you again for your interest and support.

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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.

Editorial

Six editions already and a lot more yet to come from Performance! Deloitte's triannual global magazine connects 28 Deloitte investment management practices with the industry and professionals at an international level.

Regular readers already know the principle. In addition to thought leadership on asset management related hot topics, regulation and tax perspectives, the magazine also regularly gives prominent investment management firms the opportunity to share their views with more than 15,000 market professionals.

After the summer break, we thought it might be interesting to share with the world of asset management the outcomes of Deloitte's practitioners' considerations and analyses on key topics such as the regulatory impact on the industry's operating model, profitability in managing assets, corporate governance and miscellaneous technical subjects, such as cross investment funds, ISAE 3402 or FATCA. The external contributions section is revving up for coming editions.

We wish you pleasant reading and would like to invite all you investment management professionals to contact us with brilliant ideas for forthcoming articles to be published in Performance.

Sincerely,

Simon Ramos
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The impacts of regulatory changes on asset management operating models

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Introduction

Understanding the nature and consequences of regulatory change has become a central task for asset management practitioners. The first UCITS Directive (1985), coupled with the introduction of the 'Lamfalussy Procedure' (2001), were clearly welcomed as facilitators thanks to their efficient legislative process and a harmonised European market. The success resulting from these initiatives went far beyond the borders of EU member states, reaching Asia, Latin America and the Middle East, where the UCITS brand gained full recognition from investors and the asset management industry in general.

The recent wave of regulation was inspired by very different considerations, the first of which has been the fear of systemic failure, following the 2008 financial crisis. The result translated in an unprecedented production of regulatory texts, widely received as business constraints with uncertain benefits for end investors and for the overall safety of the financial system.

With this controversial background in mind, this article explores the impact of multiple regulatory reforms on the asset management industry. In order to reach pragmatic findings, we assess this impact on key

components of the asset management value chain. While this approach may not cover the completeness of standard regulatory analysis, it facilitates the formulation of general observations and ultimately leads to thought-provoking findings on the way companies define their target operating model.

This article will tackle some key points to be considered in relation to various aspects of the asset management value chain, such as client relations, distribution, reporting, product development, technology, operations, and asset management following the enforcement of Solvency II, AIFMD, RDR, UCITS IV and FATCA.

In the current environment, we argue that it is in the best interest of asset managements to question the appropriateness of ad hoc approaches to regulatory analysis. In a period of growing regulatory pressure, holistic analysis should prevail and will ultimately better support decision-making on the definition of future operating models.

The combined effects of these regulations, and their potential influence on future operating models, will be examined in the final section of this article.

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1. FATCA

Foreign Account Tax Compliance Act

The FATCA provisions of the HIRE Act are effectively anti-avoidance measures aimed at capturing the appropriate taxation of U.S. persons on their investments outside the United States. These provisions impose a 30% withholding tax on gross income, capital and other payments derived from the U.S. (collectively known as 'withholdable payments') unless Foreign Financial Institutions (FFIs) – including non-U.S. funds and/or asset managements – enter into an FFI agreement with the IRS to provide details of all U.S. investors, whether they hold their investments directly or indirectly.

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With due diligence beginning in 2013 and full compliance required by 2015, implementation of the FATCA directive will seek to obtain information about investments held overseas by U.S. persons from the FFIs administering those investments. To comply, an FFI will need to obtain information on every holder of every account across its group, observe procedures to identify U.S. accounts and report annually on any U.S. account.

Under the agreement, FFIs assume significant new responsibilities with respect to documenting account owners and reporting accounts of U.S. persons to the IRS. If the FFI is unable to obtain the requisite client information, the client account is considered recalcitrant and the FFI must withhold 30% on the withholdable payments allocated to that client.

Clients

Asset managements will need to familiarise themselves with the requirements of the legislation and its impacts for their organisation, before diligently reviewing their existing client base to identify those clients eligible as U.S. persons. Both direct and indirect investors will need to be identified, for existing clients and new clients going forward. The effort to identify eligible clients will necessarily be signed off by the asset management's Chief Compliance Officer or equivalent.

Asset managements also need to consider what additional information they will require from clients pertaining to their U.S. person status, or otherwise. Communication with clients will need to articulate FATCA and its impacts and set out the rationale, and reassurances, appropriate to any supplementary information requests of the client.

Consideration will also need to be given to data privacy laws in the applicable jurisdictions and any conflicts between these and the new FATCA reporting obligations. Where local laws prevent reporting under FATCA, then client waivers may need to be sought or, ultimately, clients offboarded. A policy will need to be developed in relation to the handling of recalcitrant clients.



Distribution

Where the delivery of investment products is dependent on a chain of multiple FFIs, these must be identified and their approach to FATCA understood, with the obligations for investor identification falling on the uppermost FFI in the investment chain.

In most cases, asset managers will need to review their relations with other institutions in the distribution chain, as the non-participation of counterparts could potentially undermine overall compliance for the asset manager.

The portfolio of investment products offered to clients and the channels via which these are distributed will need to be reviewed and their implications for FATCA compliance understood.

Operations

Asset managers will need to implement controls and procedures across the value chain, from client onboarding to product distribution and reporting, in order to both monitor and demonstrate compliance.

Significant changes to client onboarding and KYC/AML procedures can be expected, as well as to the downstream application of withholding logic and consequent reporting.

Where asset managers employ external service providers (e.g. transfer agents, custodians, sub-custodians, etc.), these should be engaged early in order to understand the interdependencies and obligations pertinent to ensuring FATCA compliance.

Technology

Under FATCA, asset managers must be able to readily review electronically searchable client data for U.S. person status. This may introduce new data availability and consolidation requirements to the asset manager's systems infrastructure for the capture, querying and reporting of client related data.

The asset managers trade and payments processing infrastructure will need to support the withholding of tax on payments made to recalcitrant account holders and non-participating FFIs, as well as calculating and publishing pass-through payments where required. This may well necessitate new functionality and reporting, as well as increased systems integration.

The additional reporting obligations under FATCA will require robust technological support to facilitate the generation and electronic submission of client U.S. person status data, pass-through payments and investor reporting.

It will be necessary for business, operations and technology stakeholders to collaborate closely in order to create the appropriate systems infrastructure, being mindful of both regulatory compliance and any consequent client-visible impacts. Investment in technological change will be necessary and should be positioned early in the overall change portfolio and budget cycle.

2. UCITS IV

The adoption of UCITS IV by the Council of the EU (2009) raised a fundamental question which still dominates the asset management industry: will the Directive translate into savings or additional costs?

Early estimates around industry savings quickly followed the adoption of the Directive, quoting figures in the region of €2 to €3 billion per year. As the Directive moved towards implementing the measures, early optimism led to a sense of reality that culminated in July 2010 with the impact assessment of the European Commission, which put the annual costs for the industry at €1 billion.

As of July 2011, fund companies need to comply with UCITS IV according to the domestic legislation of their respective member states. As of this date, not all EU member states have transposed the Directive into national law.

Clients

Overall, investor protection and enhanced risk management will instill an additional dose of product transparency. One prominent example is provided by the Key Investor Information Document (KIID).

In essence, asset managements are asked to assist investors in making an informed decision before investing in a fund. The new requirement replaces a 30-page document with a standardised 2-pager written in the 'plain language' of each country of distribution.

The KIID is a pre-contractual document, of which the regular maintenance and delivery will have to be guaranteed by the management company. One specific element of client disclosure focuses on the level of risk associated with a fund. The Synthetic Risk and Reward Indicator (SRRI), that will have to be included in the KIID, aims at telling investors how risky a fund is through the assignment of a single number between one and seven.

The central question remains whether the KIID will succeed in fostering trust between the fund industry and investors via a transparent risk/reward communication. For the initiative to be rated a success, one would expect a reduction, compared to previous years, in the levels of investor damage and complaints.

Distribution

The SRRI introduced by KIID may have also an impact on product distribution. Considering that the risk/reward figure will aim at aligning investor profiles and investment products, this factor may lead to a potential review of portfolio composition at the level of, for instance, discretionary asset management.

The regulation of master-feeder structures is an essential component of the Directive, allowing room for the rationalisation of fund ranges. This should, in turn, generate savings expected from lower operational, distribution and marketing costs.





Previous UCITS versions continued to insist on a country-specific approach to distribution, via product passporting or multi-domiciliation. UCITS IV allows the establishment of a single structure (master fund) with multiple feeders in other EU countries. This should expedite fund launches across member states while tailoring single feeders to the cultural specificities of national markets. In addition, prevailing national rules on marketing have the potential to prevent the uptake of master-feeder structures from industry players.

Regarding UCITS cross-border mergers, the ambiguity over tax treatment remains a significant obstacle to targeted economies of scale. Appetite for cross-border mergers may also be restrained by the obligation to notify shareholders, potentially resulting in asset leakage. The market estimates this outflow risk to be between 15% and 25% of assets under management for merging schemes. A further hurdle on this topic might be the high cost related to shareholder notification. A cross-border distributed fund range of approximately 50 sub-funds may face shareholder notification fees of between €500,000 and €1 million. Considering that for managed schemes it is the management company that absorbs merger costs, it is not surprising to note that some fund houses have anticipated the implementation of UCITS IV and already performed cross-border mergers to avoid such fees.

Technology/operations

Cross-border mergers face significant operational challenges. The initial design of EU policymakers was to achieve greater operational efficiency by reducing the number of funds operating across different jurisdictions.

As mentioned above, fund managers will have to notify all investors, including those in the receiving funds, of the merger. The impact of this requirement on costs may reach levels at which asset managements will question the rewards of the merger in the first place.

Maintaining entire fund ranges while multiplying master-feeder structures might ultimately have the unintended consequence of increasing the number of funds in Europe, limiting the potential operational efficiency gains the Directive is seeking to achieve.

On top of tax constraints, the KIID will clearly generate a need for investments in technology, able to support the process from initial drafting to final dissemination, including regular data maintenance. Asset management firms can overcome this challenge internally, but many players will select strategic partners or external service providers in order to outsource all or part of the value chain. It should be noted that as a result of a Deloitte Luxembourg survey on the matter, 63% of management companies have decided to adopt a hybrid KIID production model on the basis of which the value chain is partially in- and outsourced.

At the level of master-feeder schemes, the regulation aims to avoid the portfolio look-through at master level, although some countries, such as Germany, might require such a look-through for tax transparency purposes. Operationally, the operating model of a look-through master-feeder scheme is quite cumbersome and may become a hurdle to the set-up. Finally, the UCITS IV management company passport will permit the remote establishment and cross border management of UCITS. This includes the centralisation of asset management, administration and risk management operations, either directly or through delegation. Many countries see this as an opportunity to become an EU centre of excellence, though issues related to corporate governance, tax and regulatory constraints are still very unclear. A holistic cost/benefit analysis is required to assess the impact of the passport on operational synergies.

3. AIFMD

The strong link between UCITS and AIFM is not only related to the regulatory aspects, but also to the narrowing frontier between long-only and alternative asset management. Alternative UCITS are more and more popular and trackers on the alternative segment (e.g. real estate, hedge funds) are a hot topic. On the alternative side, more and more managers are listed on stock exchanges.

Coming back to the regulatory aspects, UCITS principles, such as custodian responsibility, the independence of the control function, valuation, management of conflicts of interest and risk management have been embedded in the AIFM Directive. This tendency towards a regulatory alignment represents an important challenge for the alternative asset management world. Remuneration in asset management is also under scrutiny. AIFMD and UCITS V are heading towards a long-term approach of risk/reward-related compensation of asset managements.

In a nutshell, AIFMD aims to create a harmonised supervisory framework for alternative asset management

In a nutshell, AIFMD aims to create a harmonised supervisory framework for alternative asset management. Instead of targeting products, the Directive will rather regulate the asset management. An AIF may appoint an asset management, but can also be self-managed. In addition, the Directive will create the opportunity for EU AIFMs (later, and under conditions, non-EU AIFM) to passport alternative funds. To avoid any confusion on the matter, it is important to note that the AIFMD will not only regulate investment funds dedicated to professional investors but every non-UCITS investment scheme. Additionally, member states can 'top up' the regulations for retail AIFs.



Investors

The Directive includes measures aiming to increase transparency towards AIF investors and regulators. Each AIF will have to periodically disclose information on assets' liquidity, risk profile, risk management, investment guidelines or leverage. Each member state may impose additional reporting requirements. This quest for transparency is a good example of the trend towards convergence between long-only and alternative asset management. For AIFs, such additional reporting constraints may be a driver for the strategic repositioning of their operating model. Whereas global asset management firms will have facilities to leverage their long-only reporting facilities, niche players will need to assess the cost/benefits of maintaining/building reporting capacities or whether to approach specialised asset-servicing firms. In terms of administration, the AIFM will be able to delegate customer inquiries to a third party. As this function is strongly linked to the administration of AIFs, this argument may be an additional lever in the choice of an in- or outsourced operating model.

Consistent with the UCITS regulation, increased transparency towards the client is a strong contributor to a harmonised and regulated framework for alternative investments, which, along with the onshore re-domiciliation trend, may in time become a key argument for the European market infrastructure. Transparency, however, goes hand in hand with infrastructural investments which may, ultimately, result in a higher entry cost to the alternative asset management industry.

Distribution

One of the major features of AIFMD is the possibility to market AIF through the EU passport. If we consider that local, private placement regimes may be abolished in the mid-term (anticipated in 2018), the distribution business case in alternative asset management shall be imminently analysed. In this context, UCITS cross-border distribution hubs may show a competitive advantage on the matter. The challenge for these experienced distribution platforms will be to adapt their market infrastructure to the alternative asset management requirements. A key consideration in this regard is the attraction of specialised alternative asset management service providers.





The establishment of AIF as a brand will also be a strong challenge in terms of distribution. The industry faces uncertainty regarding the cross-border investment appetite for EU AIF. For example, Cayman funds are comfortably leading the Asian alternative assets industry. The success of the EU AIF may also depend on the positioning of Switzerland or the Channel Islands. A strong market infrastructure would require a local concentration of the complete alternative investment funds value chain, including front-office activities. The centralisation of third-party asset-servicing vendors may become a driver towards an outsourcing-based operating model in the alternative asset management world. This would require a reconsideration of the paradigm driven by the hedge fund model, in which the manager also performs ancillary services in addition to portfolio management. A further question in this regard is whether AIFM are in a position to operate extensive fund distribution strategies.

Briefly turning to Solvency II, let us note that insurance companies are strong consumers of private equity. As the capital requirements of insurance companies will become correlated to private equity investments, their appetite for this asset class may be mitigated.

Operations

In addition to portfolio and risk management, both considered as core functions, AIFM is responsible for marketing, administration and assets related activities. If the AIFM have objective reasons, the Directive offers opportunities to delegate functional areas related to the AIF operating model. It is important to note that delegation does not discharge the AIFM from his liabilities and should in no instance stimulate the setup of letter-box entities. For any delegated activity, including non-core business related functions, the AIFM must be in a position to supervise its delegates. Delegation of administrative functions to specialised service providers can be an interesting approach for asset management players willing to realise economies of scale by concentrating operational expenses on their core activities.

It should although be noted that an AIFM will need to set up appropriate initial and ongoing due diligence processes with its delegates. Such processes can be quite cumbersome as such reviews shall cover various aspects of the delegates operating model, such as financial capitalisation, legal, corporate governance, IT and core processes. An annual update of the due diligence can be considered good practice. Even if such reviews will not systematically be performed on site, a successful due diligence still requires considerable resources and expertise. Before deciding on the delegation model, the AIFM shall analyse their appetite and ability to set up a sustainable due diligence process.

Product and asset management

UCITS and AIFM regulation is driving towards the establishment of a level playing field for a potential convergence between long-only and alternative asset management. One of the envisaged outcomes is the possibility to create a 'super management company' capable of managing both UCITS and AIF product types. ESMA Level 2 guidelines on AIFMD explicitly state that UCITS management companies can manage AIF (if they become regulated as an AIFM and meet the additional related requirements). Global asset management firms will naturally seek out potential synergies among their different geographical locations. The target management company operating model will navigate between the setup of subsidiaries, potentially structured as centres of functional competences or as one-stop-shop type management companies. Decision-making on the target management company operating model shall be made in light of a thorough assessment process. From a fiscal perspective, direct tax (corporate tax, carried interest, capital gains double tax treaties) and indirect tax aspects play a decisive role in terms of cash flow optimisation.

The selection of the optimal operating model will require an analysis on the existing track record and market share in asset management (infrastructure and people), proximity to distribution channels (e.g. wealth management), political and regulatory flexibility and stability, or reactivity for new product strategies.

Remuneration is another hot topic under AIFMD. Similarly to the banking sector, the Directive will regulate remuneration of managers and impose maximum cash remuneration over a timely, scalable horizon. Hedge fund managers scrutinise this topic, which will be a key driver behind the decision to opt for the AIF brand.

One of the envisaged outcomes is the possibility to create a 'super management company' capable of managing both UCITS and AIF product types

4. RDR

Retail Distribution Review

In June 2006 the FSA launched the Retail Distribution Review (RDR) as a strategic initiative intended to address the *"insufficient consumer trust and confidence in the products and services supplied by the market"*. The proposed regulatory framework will focus on several key aspects of the distribution of both retail investment products and corporate pensions:

- i. Status of advice
- ii. Transparent industry charges
- iii. Standards of professionalism
- iv. Platforms

The RDR comes into effect on 31 December 2012, by which time all advisers in the retail investment market must be compliant. The regulation will significantly alter the shape of the intermediary market and will undoubtedly affect distribution models, while the removal of commission from new retail investment products will create a shift in the value chain and market economics. A thorough understanding of the necessary changes and a proactive strategic response will be paramount to future competitiveness in the market. Strategic responses to the RDR will vary in the degree of change involved, but all will require significant changes to business and technology operations.

We believe that the RDR provides those investment managers who are willing and able to identify the impacts of the RDR across their businesses and to define an early strategic response with a considerable opportunity to distinguish themselves from the rest of the market.

Distribution

The obligation to classify the services offered to consumers as either 'Independent' or 'Restricted' advice should prompt asset managements to carefully assess their distribution models. Once firms have determined the optimum split between their advice, execution and asset management functions they will need to adjust their business plans accordingly and redefine the charging structure in each area. Some have, for instance, already separated their advisory business from their execution functions.

Charges and profitability

The RDR stipulates that all payments for advice and related services must be made through 'adviser charges', to be agreed upon upfront with the client, and should directly reflect the services being provided and not the product recommended. Product providers will be banned from offering commission for new advised sales but may continue to pay commission for 'legacy business'.

There is uncertainty in the market regarding the implications of the proposed fee structure. Firms may offer funds with multiple share classes in order to facilitate adviser charging, which could lead to increased costs, administrative difficulties and potential barriers to competition, as well as undue complexity for the consumer. Firms are hesitant to define their revised fee structures in the absence of authoritative guidelines and in advance of the rest of the market.



The regulation is likely to prompt firms to create separate unit classes in the form of direct sales, advised sales and platform sales. Asset managements should consider streamlining their product offerings in order to improve clarity and mitigate the complications and costs inherent in providing parallel support for products sold both pre- and post-RDR. There is also uncertainty over the FSA's ability to approve a significant number of new funds in the run-up to the implementation of the RDR.

Performance reporting

The introduction of cost transparency will make the market much more price-sensitive and performance driven. Business retention will be contingent on the capacity to demonstrate that the levels of investment performance merit the charges applied. This will further emphasise the importance of having both the operational and IT infrastructure in place with which to provide accurate and sophisticated performance analysis to clients.

Platforms

The RDR is part of a much wider transformation in the retail investment market, led by major technological advances, such as platforms and changes in customer behaviour. Over recent years the market has become increasingly e-dominated and the products are becoming simpler and more modular. As a result, platforms have emerged as a key feature of the investment landscape. As the market moves towards RDR compliance, this trend looks set to continue as intermediaries change their expectations of product and platform providers with regard to fee facilitation and disclosure.

In an effort to increase the transparency of platform charges and the efficiency with which they deliver asset management services, platforms will be subjected to the same rules regarding 'adviser charging' and 'independence'. They will not be able to influence adviser payments or offer payments themselves but can facilitate payments agreed between the client and adviser. Platforms will also be required to develop new processes that will enable consumer voting rights, confirmation of client instructions, re-registration, etc.

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5. Solvency II

The European Commission's Solvency II Directive is scheduled to come into effect on 1 January 2013. Once implemented, it will mark a fundamental change in the prudential regulation of the European insurance industry and will transform the way insurance companies run their business. A survey conducted by IMA in 2010/2011 found that insurance assets accounted for 24% of the total assets managed in the UK. As such, the new wave of regulation will undoubtedly have a significant impact on the asset management industry.

Asset managements closely affiliated with insurance companies have begun to undertake Solvency II implementation projects and are now identifying the key impacts for their operations.

The framework for Solvency II comprises a mutually reinforcing three-pillar structure.

- Pillar I considers the quantitative capital requirements of the system, including the calculation of technical provisions, the rules relating to the calculation of the solvency capital requirements and asset management. The proposed framework defines two levels of capital requirement, the Minimum Capital Requirement (MCR) and the required level, Solvency Capital Requirement (SCR).
- Pillar II deals with the qualitative aspects of a company's internal controls, risk management process and the approach to supervisory review. It will require insurers to be able to calculate their risks and capital requirements in a controlled and auditable way that is demonstrably used in business decision-making. The pillar includes the Own Risk and Solvency Assessment (ORSA) and the Supervisory Review Process (SRP). Higher capital requirements may be imposed should the SRP deem the firm's assessment of risk based capital or the quality of risk management inadequate.

- Pillar III is concerned with enhancing disclosure requirements to promote market transparency. Whilst the regulation's consequent asset data requirements are still emerging, some key obligations for insurers and, thereby, asset managements are becoming clear. Generally speaking, data quality, in terms of both accuracy and scope, will need to improve as well as the frequency with which it is reported.

Solvency II is presenting opportunities and challenges for asset managements. Those asset managements who recognise these opportunities and address these challenges early will have a competitive advantage over their peers.

Product development

The new capital requirements under Pillar I will have a significant impact on insurers' asset management processes. As insurers take steps to reduce balance sheet volatility and investment risk they will be prompted to review the mandates they award to asset managements, placing them under greater scrutiny. Those asset managements that adapt to develop new products to match the underlying cash flows with the cash flow obligations of their insurance clients can expect to see increased inflows. Insurers will seek tailored, innovative products from their asset managements that reflect their risk tolerances and generate returns that more evenly match their liabilities, so as to minimise their capital requirements.

For collective investment schemes, insurance clients will be required to look through to all of the underlying holdings in those funds, such that all the relevant stresses can be applied. Otherwise, insurers must assume that the fund's mandate has been applied to generate the maximum overall investment charge or, alternatively, accept an equity risk charge.



Alternative assets are expected to attract the highest levels of capital requirements, including hedge funds, private equity, commodities and non-EEA/OECD shares.

Operations and technology

Updated quantitative methodologies in response to the Pillar I changes will require more detailed investment data to be passed from the asset management to the insurer. In turn, this may well necessitate additional information flows between the asset management and custodians and administrators. The requirements for more detailed analysis of risks and sensitivities will undoubtedly increase the data granularity required from asset managements, as asset managements have to respond to increased data volumes and cater for the differing information requirements of their insurance clients.

Any agreements between asset managements and insurers regarding the provision of outsourced investment services must reflect the obligations of the insurer under Solvency II to avoid impairing any related governance systems, unduly increasing any operational risk, impairing visibility for the supervisory authorities (e.g. FSA) and undermining continuous and satisfactory service to their policy holders. Asset management agreements and service level agreements may need to be updated to reflect the changing risk management requirements of insurance clients and the auditor's appointed by insurance clients may require access to asset managements in support of their testing of internal controls.

Early analysis of their related process, data and technology architectures will help asset managements identify any requisite changes, simplify project plans, avoid duplicate work and thereby reduce implementation costs. Early compliance is likely to create a distinct competitive advantage over peer organisations.

Risk management

In response to the Pillar II directives, insurers will want to invest with asset managements that can evidence minimal operational risks, given the requirement for them to understand and manage all of the risks to which they are exposed, including those relating to outsourced investments and investment services, with insurers needing to quantify the risks embedded in the asset management.

Asset managements will consequently need to present their risk management frameworks, procedures and controls to existing and prospective clients. Evidencing the management of investment risks is likely to prove a challenge in the absence of an established certification protocol and given that regular due diligence reviews are likely to prove unsatisfactory. It is possible that the new ISAE 3402 report could be expanded to provide assurance over the Solvency II data provided. Insurers will need to monitor the risk management provision of their asset managements and their products on an ongoing basis.

Reporting

The market discipline called for by Pillar III will lead insurers to seek out those asset managements who can provide quality data in a timely and reliable fashion. This will become an imperative for those asset managements seeking to attract insurance clients.

Reporting will be expected within days of each quarter end in order to support insurance clients in meeting the proposed reporting requirements to regulators of 20 business days (after the elapse of the transitional period in 2015). Furthermore, compliant insurers must be able to respond to supervisor queries promptly, providing supportive quantitative information. This will, therefore, require the same level of promptness from asset managements in service of their insurance clients.

Conclusion

Investment managers are currently faced with a wave of regulatory change as the market and its regulators respond to identified systemic risks and strategic restructuring takes place. The ways in which investment managers choose to navigate this turbulent period will have repercussions on their market positioning and investor perceptions, as well as on the ultimate cost and success of their response plans.

Managing the regulatory change portfolio

It is our recommendation that investment managers adopt a holistic approach to this portfolio of regulatory change. Doing so will ensure an efficient approach to navigating the suite of mandated changes, which clearly overlap and share dependencies and tensions in many areas. In an ever more cost-conscious environment, ensuring that response efforts are not duplicated or divergent is critical.

An overall response plan and coordinated execution strategy will help to ensure a joined-up approach to managing the impacts and associated costs of change. The budget for discretionary change initiatives will be further eroded by this weight of regulatory-led change in the coming 24 months, and so the minimisation of response costs will help to preserve resources for other, more strategic, business-led change.

Investment managers will need to continue to monitor the pipeline of regulatory change, both within and across jurisdictions. For example, an EU-wide variant of the RDR could follow in the coming years, as well as responses to the US-initiated FATCA directive from other tax regimes.

Guiding clients through the turbulence

A key challenge for investment managers in these turbulent times will be managing clients through the raft of changes. Whilst it will be important to ensure transparency and full information for clients, the risk of communication fatigue is very real. Investment managers will need to employ a coordinated, coherent and efficient communication strategy to ensure that their clients are eased through the turbulence, whilst minimising the number of touchpoints and avoiding repeated requests for client action or information.



There is, though, an opportunity here for investment managers to positively differentiate themselves from competitors in the guiding of their clients through this period of change, but also a real risk of client attrition if their response is perceived to be disjointed.

Adopting a 'wait-and-see' approach to some of these changes, such as the RDR, may make good sense from a business strategy perspective, but client awareness must be managed in the meantime; otherwise the information vacuum will be filled by others and client concerns and misperceptions allowed to develop.

Revisiting the product and client mix

The impacts of this suite of regulatory change will undoubtedly force investment managers to review the product mix they offer to clients and the ways in which this is distributed. Furthermore, investment managers might do well to review the client base they serve and its segmentation. Ultimately, the obligations of these regulations and their direct impact on fees and charging structures will necessitate the review of both client and product profitability. If investment managers are to position themselves competitively going forward then adjustments will most likely be needed to their investment offerings and the client business they seek to attract and retain.

Stealing a march

Investment managers have been hesitant, at best, in their responses to many of the above regulatory directives. Whilst the inevitable uncertainties and pending details have engendered a 'wait-and-see' approach from many, the opportunity to get ahead of competitors is significant. The planning of a coordinated response and the early management of client perceptions can commence now and could open up a genuine competitive advantage over peer organisations.

	FATCA	UCITS IV	AIFMD	RDR	Solvency II
Clients	Client communication strategy				
Products and distribution	Client onboarding and ongoing data management for U.S. person status	Requirement to produce Key Investor Information Documents (KIIDs) for eligible products	- Predefined client and regulatory communication channels to be set up - Customer enquiries may be delegated to third parties	Client expectations regarding transparency on charges and the professionalism of investment advice	Insurance clients are facing new and increased capital requirements
	Decision to seek FFI status	Potential rationalisation of fund ranges following master-feeder regulation, which may reduce distribution costs and expedite fund launches	- Regulation of the AIF asset manager rather than the product - Regulation will cover all non-UCITS investment schemes	Segregating advice from non-discretionary and execution-only investment offerings	Demand for innovative products that meet the risk appetite and underlying cash flow needs of insurance clients' liabilities
	A need to review product distribution chains and the FATCA stance of counterparts	A strengthening case for cross-border management companies, pending local tax changes	Potential for cross-border distribution hubs and 'Super ManCos' for UCITS and AIF	Revised fee structures: commission for legacy in post-RDR products	Look-through requirement for collective investment schemes
		Regulatory convergence for long-only and alternative products		The anticipated growth of platforms	Capital requirements, especially for alternatives
	Obligation to review electronically searchable client data	Production and publication of KIIDs, which will require coordination and monitoring	Additional reporting obligations likely to necessitate investment in technology	Increased expectations of transparent, granular performance reporting	Increased data requirements and volumes necessary to support updated quantitative methodologies
	Technology and operations	Applying withholding tax to all U.S.-sourced payments for recalcitrant clients	Look-through required for master-feeder schemes, which may be difficult to operate	Opportunity for greater delegation of some commoditised business activities (but not liability)	
Additional reporting required to clients and regulators to demonstrate compliance		Management company passports enabling UCITS cross-border management			A need to minimise operational risk and evidence risk management frameworks
		Product rationalisation may enable operational cost savings			Reporting within days of quarter end and prompt query resolution

Added value brought to the asset management industry by cross sub-funds investment techniques

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The cross sub-funds investment technique enables a sub-fund to invest in another sub-fund within the same umbrella. It also offers the investment fund industry business, operational and cost efficiency opportunities.



A look at this strategy

This feature is already permitted by many European legislative frameworks, such as in Ireland, France, Jersey, Guernsey, Germany, Italy and Switzerland, and also outside Europe, e.g. in Singapore. In Luxembourg, it was authorised when fund legislation changed pursuant to the transposition of UCITS IV into national law.

Exploiting business opportunities offered by cross sub-funds investment

Cross sub-funds investment creates interesting opportunities for the investment fund industry, of which two are worth examining:

- 1) The seed money effect consists of the possibility to increase the Total Net Assets (TNA) of a sub-fund for marketing and cost efficiency purposes. A newly launched sub-fund or a sub-fund with low TNA may invest in other sub-funds of its umbrella to increase the TNA. This objective may be pursued for two reasons. First, it reduces the Total Expenses Ratio (TER), as the burden of fixed charges will be shared by a larger number of share/unit holders. Second, a higher TNA has a marketing impact and demonstrates the attractiveness of the sub-fund to potential shareholders.

“Seed Money (...) demonstrates the attractiveness of the sub-fund to potential shareholders”

Furthermore, this technique makes it possible to reach a certain level of TNA without requesting further investments from promoters.

- 2) Managers use the cash sweeping technique to improve cash management within an umbrella structure. It consists of creating a money market sub-fund for use by the other sub-funds in the umbrella structure as a cash management facility. Instead of keeping cash on hand in their assets, the sub-funds will invest in a liquid money markets sub-fund that manages the entire structure's cash globally and more effectively.

“Cash sweeping (...) delivers better returns on short term assets”

This technique reduces each sub-fund's cash requirements and allows investment managers to proactively manage cash and earn better returns on these short term assets.

Cross sub-funds investment generates other business opportunities, including the possibility of broadening the range and diversity of products offered to clients and shareholders, better investment liquidity and better visibility for investment managers. Assets remain in the umbrella structure and offer investment managers and advisers greater investment flexibility. Overall, this should boost share/unit holder confidence significantly.

Navigating the challenges

When using cross sub-funds investment, funds and management companies must address specific challenges. The danger of a conflict of interests is clearly one of these. Management companies and self-managed funds must ensure at all times that UCITS are fairly managed in order to minimise the risk of conflicts of interests. A set of clear and specific procedures must be implemented for cross sub-funds investment to identify and prevent potential areas for conflict of interests (litigation, net asset value calculation errors/non compliance notifications, late trading, liquidity management, compliance with investment policy and best practices in the interest of shareholders).

In the long term, the introduction of procedures that effectively address the risk of a conflict of interests will be regarded as a marketing advantage for the fund.

Stakeholders will also have to be informed about the procedures introduced in order to avoid any reputational risk due to suspicion of conflict of interests. Once implemented, these procedures will most likely be considered as a marketing advantage for the fund.

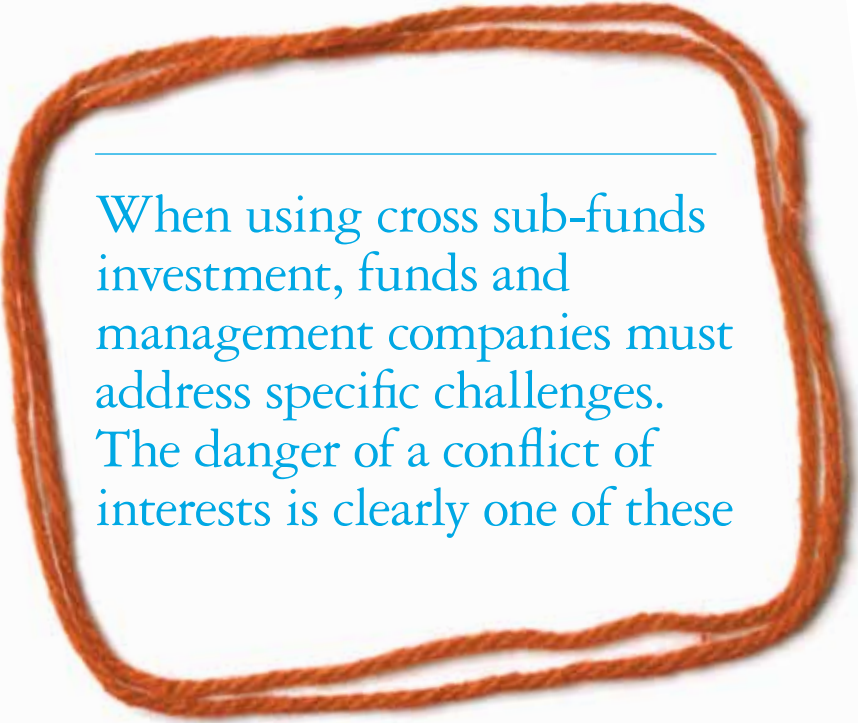
The fund and the management company may have to take local restrictions on distribution into account, especially for distribution outside the European Union.

Gaining operational efficiency and improving cost structure

Beyond the business and management opportunities offered by cross sub-funds investment, operational efficiency gains are expected. Easier access to information and harmonisation of accounting, pricing and the transfer agent system are key sources of efficiency. Reconciliations and the pricing workload of administrative agents will be reduced; compliance monitoring will be facilitated by the knowledge of the underlying sub-fund in which the UCITS/UCI is being invested; availability of the information for risk monitoring at management company level will be improved. Last but not least, cross sub-funds investment can be seen as an alternative to the pooling system, which may turn out to be costly and is not a service currently offered by all administrators on the market.

Business opportunities and efficiency gains have a positive impact on the TER of the fund, thereby increasing the attractiveness of the fund. Easier operating processes and the ban on double dipping will positively influence the cost structure of sub-funds that use cross sub-funds investment. Such sub-funds may also benefit from the rules applicable to all funds of funds when calculating subscription tax.





When using cross sub-funds investment, funds and management companies must address specific challenges. The danger of a conflict of interests is clearly one of these

Compliance and audit

Funds using cross sub-funds investment are still subject to investment restrictions and limitation rules, in accordance with the Law in the jurisdiction where the funds are registered. These rules are intended primarily to prevent the cascade investment and define the quality criteria of the UCITS and UCIs in which a UCITS can be invested, as well as the investment limits and the diversification requirements. Additional restrictions may be introduced.

As for countries such as Luxembourg or Ireland, we must consider the following:

- 1) Circle investment: *"A target sub-fund must not invest in turn in the sub-fund that has invested in this target compartment"*
- 2) Voting rights attached to the underlying sub-fund are suspended for as long as they are held by a sub-fund of the same umbrella
- 3) The value of sub-funds acquired by other sub-funds of the same umbrella is not taken into account when calculating the TNA of the UCI for verifying the statutory minimum capital requirement
- 4) Double dipping of management/subscription or redemption fees is prohibited by UCITS IV
- 5) The possibility of using cross sub-funds investment must be mentioned in the fund's articles of association and in the prospectus

Conclusion

We are all aware that the face of investment management is changing, through falling revenues, persistent cost pressures and increasing competitiveness. Asset managers will need to build flexible operating models focusing on operational excellence, business resilience and most important, converging interests between asset managers and investors.

In this context, cross sub-funds investment is another string to the bow of investment managers that offers a convenient way to bring new products to market and leverage performance track of existing schemes.

Asset management in a post-crisis environment

Reconsidering profitability

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The 2008 financial crisis caused a severe drop in asset valuations and a sharp decline in revenue. The subsequent and intense pressure on fees has, at times, called into question the profitability of the prevailing industry model.

Why focus on profitability?

Earlier in the year, there was evidence to suggest that the overall economic picture was improving, so the industry grew increasingly hopeful of a potential return to a pre-crisis environment. These positive trends have, however, proven to be both temporary and weak. The debt crisis, slow economic growth, foreign exchange imbalances, continued high unemployment in the U.S. and a number of catastrophic natural disasters (including the earthquake in Japan) have all dampened hopes of a strong recovery. Thus, whilst asset managers enjoyed a comparatively positive investment climate in 2010, 2011 is proving to be more challenging.

Indeed, the key trends in the asset management industry that were evident in the aftermath of the financial crisis are still prominent today and may become further entrenched by the destabilising factors noted above. These trends are unlikely to reverse in the short to medium term.

This reflects the fact that the post-crisis world is fundamentally different to the pre-crisis environment. Deep paradigm shifts are evident in the structure of the global financial services industry, and this has significantly affected the cost-income ratios of asset managers.

Taking this into account, asset managers need to make fundamental changes to the way in which they conduct business to ensure their survival and improve their cost-income ratio. Focus on profitability management is critical.

This article reviews current market trends in the asset management industry, looking at how they impact profitability. It then highlights the importance of access to high quality information and the implementation of a profitability framework to better enable strong profitability management and direct focus towards areas capable of generating sustainable value.



Ongoing pressure on revenue and increasing costs: current trends here to stay

The key trends highlighted below are becoming increasingly entrenched and are threatening asset managers' profit margins from both a revenue and cost perspective.

Risk-averse clients: There has been a fundamental, perhaps even irreversible, alteration in client psychology. Investors have become increasingly risk averse and continue to limit the volatility of their portfolios, preferring absolute returns and guaranteed income from investments and cash holdings. Fear and mistrust still linger in the market, though to a lesser extent than immediately after the worst of the crisis.

Changing fee structures: Another characteristic of the post-crisis investor landscape is the increasing focus on value for money. Many asset managers are finding that clients are demanding a fee structure that is linked more closely to performance than in the pre-crisis market.

Passive products: More passive assets with very low management fees are becoming increasingly popular, at the expense of active products with high fees that no longer generate the sort of alpha possible before the crisis. Indeed, in today's environment, because of the higher fees demanded by active investment managers, net returns after fees can be lower than returns from beta products. Global Exchange Traded Fund (ETF) assets rose 28.2% in 2010 to \$1,482bn¹, and it has been estimated that the portion of global assets being managed passively could rise from 15% to 25% in the next ten years². Over 1,000 new ETF products could be launched in the market during 2011³.

Demographic change: There may be opportunities for asset managers as younger generations become increasingly aware of the need to make early provision for retirement, growing unfunded public sector pension liabilities, and lower returns on regular bank deposits. However, this must be balanced against the effect of ageing populations. As affluent baby boomers enter retirement, demand for asset protection and draw down will increase, and there will be a slower accumulation of assets.

Increased regulation: In addition to falling revenue, the cost base of the industry is increasing, primarily due to the need to comply with a greater regulatory burden. New regulation will mean increased capital requirements, leverage limits, new disclosure requirements and changes to remuneration. The Undertakings for Collective Investments in Transferable Securities (UCITS) IV Directive, effective from July 2011, introduces new provisions including new rules for fund mergers, new rules for master-feeder fund structures, key information documents for investors, more efficient notification procedures and asset management company passports. The Alternative Investments Fund Managers Directive (AIFMD), a European directive that will come into effect in 2013, aims to provide more transparency, robust governance and improved solvency within the alternative investment sectors (mainly aimed at hedge funds and private equity, but may extend to traditional asset classes). The Foreign Account Tax Compliance Act (FATCA), signed into U.S. law in March 2010 and effective from 1 January 2013, significantly tightens the tax reporting requirements of non-US financial institutions. Ensuring compliance with this stream of new regulation, of which the above is only a selection, will involve a substantial investment of time and money from asset management firms.

¹ 'Rapid expansion across UK exchange traded funds industry', *Financial Times*

² 'Investment industry set for big shift into passive management', *Financial Times*

³ 'Fixed Income ETFs are just getting started', *Financial Times*



Improving profitability to deliver sustainable value

Asset managers need to find ways to improve profitability, control the impact of the increasing pressure on the bottom line, and take advantage of potential new opportunities presented by today's market. Asset managers that have a clear understanding of the way their business works and a view of key financial metrics will be prepared to counteract the effect of the current market trends. The availability of certain types of information is vital. If asset managers are able to positively answer the following questions, they will be better placed to make strategic decisions and improve medium to long-term positions:

- Do I understand which products and clients are the most profitable?
- Do I understand the distribution channels that bring in the assets with the highest margins?
- What do I know about the products that generate the most fees?
- How clear is my vision of the major growth opportunities ahead?
- Are there processes in place to produce information and profitability metrics on my organisation, and can I access this information on demand?
- Does this information allow me to clearly see which products, clients, distribution channels and jurisdictions generate revenues in my business, and how?
- Does this information provide me with an accurate and thorough view of the cost drivers of my business?

To answer the critical profitability questions, there may be a temptation to embark upon a one-off ad hoc tactical solution. However, a pragmatic, structured, and comprehensive approach to profitability management will deliver sustainable benefits. Profitability management should therefore be one of the key components of strategic management.

Profitability management is complex and asset managers often struggle to obtain a clear picture of how profitable their products, clients, services and distribution channels are. Ideally, a framework will be established to facilitate the analysis of these four areas.

Depending on the profitability 'angle' chosen (products/services, clients, distribution channels or jurisdictions), the framework should cover three key areas to provide an accurate view of profitability:

- Revenues (e.g. gross revenue, trading revenue, revenue commissions/expenses, key allocation types and organisation)
- Costs (e.g. people-related costs, non-people related costs, allocations, distribution, key allocation types and organisation)
- Profitability rules (e.g. governance model, financial control line items and aggregation levels)

This can prove challenging, but this approach will allow asset managers to take control of their business and be equipped to make decisions based on tangible profit levers, enabling competitive gains. Activities such as product alignment, cost reduction, sales and marketing pushes, re-alignment of infrastructure and systems, and changes to the service model can then be undertaken with the knowledge that this is strategically the right course of action for the business and with a clear picture of what the financial benefits should be.

Proactive management of profitability is key to navigating the post-crisis environment

The global financial market has been fundamentally altered as a result of the financial crisis and revenues in the asset management industry have been significantly impacted. These revenues are unlikely to revert steadily towards pre-crisis levels due to increasingly risk averse, value seeking investors, competition from passive products, changes in fee structures and the impact of demographic change. In addition, cost bases are increasing significantly because of the higher incidence of regulation. As a consequence, the cost-income ratio in the asset management industry is worsening.

Asset managers must focus on the profitability of their businesses, and will have to proactively manage profitability if they are to survive in this new landscape.

Easily accessible, structured, and up-to-date information on the business is required to support coherent decision-making. This is essential to avoid one-off tactical solutions to bridge the information gap. Asset managers need to re-focus their businesses on areas capable of generating sustainable value in this challenging environment, and as such, need to ensure that the right information is accessible to them on demand.

Asset managers must focus on the profitability of their businesses, and will have to proactively manage profitability if they are to survive in this new landscape

Operational taxes and FATCA

The fly in the ointment for the global funds industry

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Operational taxes have, in recent years, become the fly in the ointment of the global funds industry. At a high level, operational taxes are those taxes which are not a direct tax on the fund or on the service provider, but rather are a compliance obligation of the fund or service provider. Examples of operational taxes include withholding tax, encashment tax, the European Union Savings Directive, the U.S. Qualified Investor (QI) rules and the new U.S. Foreign Account Tax Compliance Act (FATCA), to name just a few. These operational taxes often involve collection and reporting of information and/or withholding of tax. In the current environment, where tax losses in financial institutions mean that many Heads of Tax have less control over their effective corporate tax rate, one of the important matters on their watch list is the area of operational taxes. For funds too, every basis point of margin is important. While operational taxes often sound like they come within the remit of the tax function, the reality is that all areas of the business are affected including legal and regulatory, compliance, operations and IT.

With a growing appetite among global tax authorities to force financial institutions into a quasi-tax collector role, identifying and managing operational taxes is a serious, but costly, business. In addition to the obvious financial costs (underpaid tax, interest and penalties, systems design and implementation, information capture, man hours), the reputational risks of non-compliance

(brand effect) and potential limitations on a fund's ability to attract investors can prove detrimental to the long-term survival of a fund or institution.

With greater complexity in investment strategies undertaken by funds comes greater risk that tax reporting and compliance may be overlooked. This is particularly the case where the responsibility cannot easily be delegated to a single business unit/party. Therein lies the greatest challenge in managing the operational taxes of a fund: identifying the party/parties responsible for ensuring compliance with reporting obligations—collating the necessary information from investors, appropriately engaging, reporting and paying the tax to the tax authorities, etc.

The concept of shifting the obligation for policing and reporting investors onto financial institutions is certainly not a new one. The U.S. FATCA rules, effective from 1 January 2013, are the latest reporting and compliance regime with which the global funds industry must come to terms and it is shaping up to be the most onerous to date.

FATCA was signed into law on 18 March 2010 as part of the Hiring Incentives to Restore Employment Act (the HIRE Act), which also included incentives for hiring and retaining unemployed workers, giving rise to its name.



While some preliminary guidance has been provided, the regulations providing clarification of FATCA will likely be issued piecemeal over the next 12 to 18 months and therefore most companies are still trying to determine the impact of this new legislation on them and their industry.

FATCA imposes a new 30% withholding tax on certain U.S.-sourced income and proceeds paid after 31 December 2012 (withholdable payments) to foreign financial institutions (FFIs) unless they have entered into an agreement with the U.S. Treasury to identify and annually report information about specified U.S. persons. The definition of a withholdable payment is broad and will include almost all U.S.-source cross-border payments including interest, dividends, royalties, rents, fees, commissions, or other fixed or determinable annual or periodic income. Additionally, a withholdable payment will include the gross proceeds from the sale or other disposition of any property that could produce interest or dividends from U.S. sources.

Based on the scant guidance that has been issued thus far, virtually all non-U.S. funds could potentially be considered as FFIs, thereby requiring them to enter into such an agreement in order to avoid onerous withholding consequences. Umbrella funds pose a unique challenge in this respect since the agreement would be entered into at the umbrella fund level and not at the level of the sub-fund or share class. This will greatly increase the amount of work to be undertaken by such a fund to identify and document U.S. persons because it will need to do so across all investors in all share classes.

FATCA also raises significant operational issues for non-U.S. funds. At the most basic level, these funds will need to make sure that all of the parties they deal with (i.e. custodians, brokers, paying agents, distributing banks, etc.) are in compliance with the FATCA rules or they are at risk of suffering withholding.

Also, it is likely that most funds will need to change the documentation requirements for their investors in order to identify U.S. persons. For the purposes of these rules, a U.S. person includes all U.S. citizens or green-card holders regardless of where they reside as well as non-U.S. persons residing in the U.S.. This is information that all funds do not currently identify. With many fund investments being made by nominee or custodial account holders, it may be extremely difficult to confirm whether the ultimate owner of an account is a U.S. person.

In addition to identifying and documenting investors, funds will also need to be in a position to track, calculate, and withhold on all or a portion of U.S. income associated with account holders that have not provided proper documentation or, if required, have not entered into an FFI agreement themselves. Since this withholding is not only required on direct payments of U.S. income but also on amounts that are attributable to a withholdable payment, funds will need to segregate their U.S. assets from their non-U.S. assets so that they can identify and trace the portion of the withholdable payment that arise from those U.S. assets.

As the U.S. Treasury contemplates and drafts the income tax regulations that will govern FATCA, European and other fund groups have submitted comment letters in the hope that once the additional guidance has been released certain fund types will be carved out as posing a low risk of tax evasion. In the meantime fund managers should be analysing the impact of the new FATCA rules on their offerings, reviewing their legal agreements and relationships and looking to their administrators and professional advisors for assistance.

FATCA operational news

On 14 July 2011, the IRS released Notice 2011-53 that provides long-awaited transitional relief from significant obligations under FATCA.

The IRS stated in the accompanying news release that the phased implementation takes into account concerns raised in comments to Notice 2010-60 and Notice 2011-34 and the desire of the IRS to provide a workable timeline for FATCA implementation. In sum, the phased procedures include the following:

1. Deadline of 30 June 2013 to enter into an FFI agreement. An FFI that enters into an FFI agreement by such date will be identified as a participating FFI and thus avoid FATCA withholding that will apply as of 1 January 2014. FFIs that enter FFI agreements after 30 June 2013 but before 1 January 2014 will be deemed participating FFIs for 2014; however, they may be subject to FATCA withholding due to the lack of time available to identify them as participating FFIs before FATCA withholding begins on 1 January 2014. The effective date for FFI agreements entered into before 1 July 2013 will be 1 July 2013 and the effective date for any FFI agreements entered into after 30 June 2013 will be the date the FFI enters the FFI agreement.
2. New account due diligence procedures generally must be in place from the effective date of the FFI agreement. The due diligence procedure of Section 1.A.2 of Notice 2011-34 for pre-existing private banking accounts with a value of at least \$500,000 will need to be performed within one year from the effective date of the FFI agreement and for pre-existing private banking accounts of a lower value by 31 December 2014 or the first year anniversary of the FFI agreement, whichever is later. For all other pre-existing accounts due diligence procedures must be performed within two years of the effective date of the FFI agreement.
3. Reporting of gross receipts and gross withdrawals or payments from U.S. accounts will not be required for the first year of reporting (2013). However, an FFI will be required to report as a recalcitrant account holder any U.S. account holder identified by 30 June 2014 for which the FFI is not able to report the information required under §1471(c)(1) (for instance due to failure to obtain a waiver from the account holder).
4. FATCA withholding begins for FDAP payments made on or after 1 January 2014. FATCA withholding for FDAP and gross proceeds will begin on 1 January 2015. Pass-thru payments will become subject to FATCA withholding no earlier than 1 January 2015 and therefore the obligation to calculate any pass-thru percentage will not begin before the first calendar quarter of 2014.
5. The IRS plans to publish the proposed regulations by 31 December 2011 and the final regulations in the summer of 2012. In addition, the IRS and Treasury anticipate issuing draft FATCA reporting forms in conjunction with the proposed guidance and final forms to be published for use in the summer of 2012.

On 14 July 2011, the IRS released Notice 2011-53 that provides long-awaited transitional relief from significant obligations under FATCA





International distribution of units in UCITS

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Abstract

In addition to cost rationalisation, attracting capital abroad could help Undertaking for Collective Investments in Transferrable Securities (UCITS) to achieve greater volume and reduce the cost of management and administration. However, fund managers have identified taxation as a major obstacle to the international distribution of units in UCITS. In this article, the key tax issues regarding international distribution are reviewed from the perspective of the unit holder. According to the author of this article, UCITS could, from a tax perspective, successfully attract capital abroad, should these funds be distributed in pre-selected member states in which the UCITS has a competitive (tax) advantage.

Introduction

The UCITS Directive lifted the restrictions on the free movement of units in UCITS within the European Economic Area (EEA). This allowed UCITS to collect capital on a pan-European basis with a single authorisation (European passport). In spite of the European passport, the cross-border distribution of units in UCITS, with the exception of round trip funds, is not common practice. Relatively few funds, only 16%, according to the European Commission, market their units in another member state, although it could help a fund gain more volume.

The size of the average UCITS is relatively small, 54% of European funds had less than €50 million in assets in 2006. By comparison, the average size of U.S. mutual funds was almost €975 million in 2006. The total expense ratio of UCITS is currently twice as high as that of U.S. funds. The unit holders pick up the bill for these higher management costs. Research has demonstrated that the cost of managing and administering UCITS decreases substantially as the volume of AuM increases, until a fund reaches €200 – 300 million. The current state of the UCITS market offers significant potential for economies of scale.



An investment in a foreign UCITS therefore may result in a tax advantage or a tax disadvantage compared to an investment in a domestic fund

Freedom to market units in another member state

The UCITS Directive guarantees UCITS the freedom to market themselves in another member state (host state). UCITS are authorised to collect capital on a pan-European basis. The authorisation granted by the home authorities is valid in the entire EEA (European passport). Authorisation of a UCITS cannot be refused by the host member state's authorities. They do, however, have jurisdiction over marketing arrangements and other rules beyond the scope of the Directive, such as taxation.

Taxation: a major obstacle or a catalyst?

Taxation has been identified as one of the major obstacles for the common market for UCITS. Taxation in the member states has not kept pace with developments in the fund industry, such as product innovation and globalisation, or with respect to the UCITS regulatory framework, e.g. international distribution. Instead, it has traditionally focused on national investments and national unit holders. In general, it is not properly designed for investments in foreign UCITS. An investment in a foreign UCITS therefore may result in a tax advantage or a tax disadvantage compared to an investment in a domestic fund. So far, the European legislator has not succeeded to provide a level playing field.

Pre-selection of member states in which UCITS are marketed

Differences in taxation create international distribution opportunities. UCITS and management companies could use these differences to market units in another member state. Because of a lower effective tax burden, a UCITS established in member state A could have a competitive (tax) advantage compared to a UCITS established in member state B. Such an advantage is beneficial to investors, which helps a foreign UCITS to market its units in another member state (the host state).

Selection of member states

By calculating the effective tax burden in advance, a UCITS could use the available resources in order to attract capital from the public only in those states in which the fund has a competitive (tax) advantage (pre-selected member states). The effective tax burden is seldom the same for private and institutional investors, because of differences in the tax base, tax rate and available exemptions between personal income tax and corporate income tax. As a result, a UCITS could, compared to a domestic fund, have a lower effective tax burden in the host state for private investors, but a higher effective tax burden for institutional investors. This should be taken into account when marketing the units in the host state.



In addition, the effective tax burden may even differ between institutional investors. Pension funds and charities are often subjectively exempt from tax, while financial institutions, like banks and insurance companies, are subject to specific tax accounting rules. The effective tax burden for the various types of institutional investor may therefore also show differences, which could affect the distribution strategy in the host state.

Successfully marketing units in another member state

A UCITS could, from a tax perspective, successfully market its units in another member state, if it avoids host states in which (or investors for whom) an investment in its units results in a higher effective tax burden compared to an investment in the units of a domestic fund. The latter depends on the type of investor, the investment policy of the fund and the tax regime of the host state.

Explanations for a higher effective tax burden in the host state

An investment in a foreign UCITS may result in a higher tax burden in the host state compared to an investment in a domestic UCITS, because of differences in:

- The time at which unitholders become liable for tax on income earned from UCITS, and the amount of taxable income
- The entitlement to exemptions from personal income tax and corporate income tax for investments in UCITS
- The taxation of distributions to the unit holders and the crediting of the tax levied on distributions by the unit holders

These differences are the result of either disparities between the tax regulations of the UCITS home state and the host state (mismatch) or unfavourable tax treatment of foreign UCITS.

Disparities

The UCITS Directive does not, for tax purposes, provide for a common rule on the beneficiary of the income from the underlying securities or other financial instruments: the unitholders (tax transparent) or the UCITS (tax opaque). In some member states the unitholders are considered to be the beneficiaries of the income, whereas other states attribute the income to the UCITS itself. In a third group of member states there is no consistent approach. A difference in the qualification of the person who is the beneficial owner of the income causes differences in the taxation in the host state. The tax due in these states depends on the person regarded as the beneficiary of the income. A difference in the beneficiary of the income affects not only the time at which income is considered to be taxable, but is also of importance for the entitlement to exemptions or a foreign tax credit.

This kind of difference cannot be eliminated by appealing to the principle of non-discrimination or the freedoms. It is therefore, from a tax perspective, not advisable to market units in such a host state, as a foreign UCITS does not compete under the same conditions as domestic funds.

Unfavourable tax treatment

Member states are sovereign in matters of taxation. The sovereignty of member states is, however, restricted by the principle of non-discrimination, as laid down in the Treaty on the Functioning of the European Union (TFEU) or the agreement establishing the European Economic Area (EEA Agreement). Member states are therefore free to introduce special tax regulations for foreign UCITS (offshore fund legislation) as long as it is applied indiscriminately. Offshore fund regulations are introduced either to establish a level playing field between domestic and foreign funds, or to avoid deferring tax by using foreign accumulation funds.

The outcome of this kind of regulation is not systematically appropriate towards the market reality. Offshore fund regulations, therefore, may result in more severe taxation for investments in foreign UCITS compared to investments in domestic UCITS, which discourages investors to keep units in foreign UCITS.

More severe taxation prevents foreign UCITS from attracting capital in the member states of the EEA. A diverging tax treatment of foreign UCITS appears to be in conflict with the freedom of capital as laid down in the TFEU and the EEA Agreement, and seems unfavourable. In respect of discriminatory offshore fund regulations the general provisions on non-discrimination in the TFEU or the EEA Agreement could be appealed to. However, bringing cases concerning possible discrimination to the highest court of a member state and/or the Court of Justice of the European Union requires time and implies cost. Alternatively, UCITS could decide not to market units in states with discriminatory offshore fund regulations and instead focus on states in which a UCITS has a competitive (tax) advantage.

Conclusion

UCITS have the right to collect capital on a pan-European basis. The European legislator has not yet implemented common rules on the taxation of investments in units of UCITS. As a result of the differences between member state (non-harmonised) tax legislation, the playing field is not level. This offers opportunities for international distribution of units in UCITS. A lower effective tax burden for investments in its units helps a UCITS to market its units in a host state. UCITS should therefore calculate the effective tax burden of an investment in its units in advance so that the available resources are used only in the states in which the fund has a competitive (tax) advantage (pre-selected member states).

Offshore fund regulations are introduced either to establish a level playing field between domestic and foreign funds, or to avoid deferring tax by using foreign accumulation funds

UCITS IV: the impact of VAT on the economies of scale expected by the professionals

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The implementation of the UCITS IV¹ Directive (“UCITS IV”) is currently under process in each of the 27 EU Member states.

Some of the regulatory changes introduced by UCITS IV have long been expected by industry professionals.

Indeed, while UCITS IV raises some questions and may need some alterations to remove its imperfections, it nevertheless represents a positive and long-awaited change to the regulatory environment within which UCITS operate. One of the principal aims is to reduce operating, asset management and distribution costs.

¹ Directive 2009/65/EC of 13 July 2009

Substantial economies of scale expected... VAT included?

In a newsletter in July 2008, the European Commission, Internal Market, estimated the expected benefits of UCITS IV at more than six billion Euros. In fact, whether through the introduction of the European passport for management companies, the Master-Feeder structure, the facilitation of cross-border mergers or the replacement of the simplified prospectus by the Key Investor Information', UCITS IV should make it possible for promoters operating in several jurisdictions to realise significant synergies.

The most emblematic of all these measures is without doubt the introduction of the European passport for management companies. This will make it possible for a management company to manage, from one Member State, UCITS established in any other Member State of the European Union.

Industry investors intend to take advantage of the introduction of the European passport to rationalise their organisation and achieve economies of scale. Reorganisation is traditionally driven by regulatory, operational and financial considerations, but the VAT impacts must not be ignored in an industry in which input VAT generally represents an expense since in principle it is either non-recoverable or only partially recoverable (the non-recovery of input VAT is the corollary of the in-principle exemption of management of UCITS).

The new management company: two models, one VAT analysis

Two main organisational models are now available to management companies who choose a member country as their only or principal place of establishment, depending on their organisational strategy and their operating model:

- A 'centralisation' model in which a management company consolidates its activities exclusively in the country of establishment and provides management services to UCITS situated in other Member States; or
- A 'branch-based' model in which a management company establishes itself in one Member State and opens branches with clearly defined roles in the other Member States of the European Union in which the UCITS it manages are established.



In the 'centralisation' model, the issue of VAT will arise, for example, on any transfers of resources and/or technology (tangible or intangible assets) to the single management company. Will the elements transferred from another Member State to the Member State in which the management company is established generate a VAT cost for the management company? Also, if contracts are transferred between entities, will VAT be chargeable on those transfers in the light of the recent case law of the European Court of Justice ('SwissRE' judgment – case C-242-08)?

Following such a reorganisation, numerous contracts previously entered into by the home institution and third party service providers established in the same Member State will very probably be amended so that the management company becomes the only co-contracting party.

Before these contracts are amended, the management company will have to consider whether there is a VAT exemption in its country of establishment that applies to all or some of the services concerned, in order to avoid the VAT of its country of establishment being charged too systematically, through the self-assessment mechanism, on all the services received.

In the 'branch-based' model, the question of VAT must not be omitted in any consideration of pooling and sharing resources between the different institutions. To avoid adversely affecting the aim of reducing the costs of a pooling project, it will be necessary to establish a structure that is efficient and secure from the point of view of VAT at the level, for example, of expenditure on IT, human resource management or any other expenditure that can be shared between the central office and the branches.



By way of example, it will be important to ensure these costs are allocated in a consistent way between the central office and its branches established in different Member States from the point of view of both direct taxes ('transfer pricing') and VAT, in order to avoid any additional tax demands in the Member States concerned. Optimisation schemes are also possible to minimise the total cost of the VAT on the expenses that are shared by the central office and its various branches.

Whichever model is chosen, the issue of VAT must also be raised when considering the rationalisation of distribution schemes, in order to ensure that those schemes do not generate additional VAT costs that a VAT impact analysis could identify in advance and, where applicable, avoid.

What are the VAT impacts of cross-border management of UCITS?

Where a company manages UCITS established in other Member States, this will also require professionals to redefine their legal relationship with those foreign funds.

There remain significant differences between Member States regarding the scope of the VAT exemption for fund management services. Professionals will therefore be concerned to establish what the relevant VAT legislation is in each Member State in which a fund is established so as to be sure that they benefit from a local VAT exemption on the services provided, in order to avoid a potential VAT cost for those UCITS.

In practice, with regard to their VAT declaration obligations, management companies will have to ensure they have the necessary data and information available in case they are required to complete a summary statement of provision of intracommunity services in accordance with the recent VAT Package.

The right to deduct input VAT paid by management companies in relation to the management of investment funds established abroad could also be the subject of a prior analysis. Effectively, modalities for a management company to recover at least part of the input VAT suffered may vary according to the country where the management company will be established.

Beyond this issue of the right to deduction of management companies providing services to UCITS situated in other Member States, professionals must, within the context of a reorganisation that necessarily increases transnational flows of services, expect relatively complex VAT issues in an area (i.e. financial-sector VAT) in which harmonisation between Member States is far from perfect (pending potential clarifications if the proposed VAT Directive on the treatment of insurance and financial services comes to fruition)

Conclusion

UCITS IV is without doubt a tool that can contribute to the achieving of the main aims of the promoters of UCITS funds, i.e. more efficient distribution arrangements, lower operating costs, optimal administration and management of funds and, finally, increased attractiveness of the UCITS 'product'.

With regard to the search for economies of scale, which is closely linked to the achieving of these objectives, the VAT aspects of reorganisations must be carefully considered to ensure that VAT does not become the Achilles heel of a new structure designed to achieve the full benefit of the measures put in place by UCITS IV.

Asset management vs. wealth care

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The private wealth management industry will undergo severe changes following the market meltdown of 2008. How will it evolve?



During the late 1990s, the hot topics in the financial markets were e-commerce and bank assurance. Both these developments were believed to be to the benefit of the consumer of financial products. E-commerce would deliver the entire universe of financial products right to the consumer's fingertips, and the assimilation of banks and insurance companies would drive costs down due to 'synergy'. Although the internet has indeed provided the consumer with all the information in the world, financial products are still not bought online to the extent originally expected.

Also, the vision of a single product factory to produce everything a client might need and push it down a single distribution channel was not on the wish list of High Net Worth Individual's (HNWI). Financial engineering and investment banks have been scrutinised following the meltdown of 2008. The lambda investor tended to show less faith in the financial services industry as a whole. So, what have we learnt?

- The bank assurance drive has led to a process whereby the financial advisor became a generalist. He or she became a 'supermarket' salesperson who could give the client a little advice on many products, but not specialist advice tailored to the client's individual needs. It wasn't long before HNWIs demanded more specialist knowledge, resources and time to be applied to their particular needs. The old adage that insurance is sold rather than bought also proved to be true, so bank intermediaries, used to having their products bought, soon struggled.

- The internet has tried to circumvent the adviser entirely. However, experience has shown that investors prefer to be coaxed through the investment process by a specialist who cares about the long-term efficacy of the proposed solution and not just the appeal of the original pitch.
- Following the catastrophes of 2008 and the ensuing economic recession, customers are showing a renewed appreciation of the old-fashioned breed of wealth-care specialists. No longer do they want distant, electronic voice-recorded sales people to advise them and then disappear after earning their fee. Customers want caring specialists to personally advise them and stay with them through the entire investment cycle, constantly providing feedback, updates and confirmation that their strategy is still appropriate.

Private client wealth management requires more than just asset management. It requires that all the aspects surrounding the assets be “taken care of”

The turmoil following the market collapse of 2008 merely strengthened the relationship between advisor and client, rather than weakening it

So how did all this affect the asset management industry as it pertains to the HNWI?

- Private client wealth management requires more than just asset management. It requires that all the aspects surrounding the assets be 'taken care of'. This implies a higher level of service and client commitment than ever before. Investors now need somebody who can handle all their investment-related matters. This holistic approach to wealth management means that larger intermediaries, with economies of scale, have the possibility to offer services to UHNWI with more competitive prices than small boutique outfits without necessarily decreasing the service level. Advisors will need to draw upon investment consulting, tax and fiduciary services, independent valuation and/or risk management services, compliance and reporting services.
- Strong relationships between clients and professionals are inevitably built on trust gained over time, which gives larger intermediaries a competitive advantage compared to small brokerages.
- Leaving clients on their own to face severe asset class storms, as uncertainty sweeps over the globe's financial landscape, has proven to be the final death knell for the small broker. HNWI's now worry more about preserving their capital than achieving the highest possible return. This heralds a period of renewed interest in guaranteed products and a search for growth uncorrelated to equity returns.

It also marks the return of the often forgotten structured product. Structured products mostly include a capital guarantee with some participation in the upside. This profile is suddenly much more appealing than during the roaring mid 2000s.

- HNWI's now appreciate the value added by a specialist asset allocator and risk manager and understand that intellectual capital of this kind must be paid for as a professional service. Global regulations have put investment product transparency on their agenda.
- The industry built on the 'self directed investor' is based on the notion of cost saving and the fact that all investment information is considered public and mostly free. This industry might flourish, but no one can yet predict this will be the right way for investors to go.
 - Yes, investors can gain access to most asset classes directly and cheaply through ETFs and other beta products. Who will advise them of the proportion of each to invest in, and when to sell? For those who believe that this exercise is simple or easy, the only way to find out is to try it. Even though buying beta might be free, the self-directed investor has no real guarantee on return.
 - Even though information is free, it does not imply that all participants have the same view. Uniform information does not lead to homogenous decisions. Nowadays, anybody can get all the information they require to remove their appendix on the internet. But how many people would actually attempt to do so? Likewise, any individual can get all the information they require about investments and investment products. So why do they assume that this would equip them sufficiently to manage their own investments?
- Fees are also an integral part of the trusting relationship between client and advisor. The client wants fairness in fees and the advisor wants longevity or a sense of permanency to fees.



What are the investment management implications of the trends described above?

- All products that were previously viewed as institutional will have to be made available to retail investors as well. This has a number of practical implications for financial institutions, which are beyond the scope of this article.
- A flood of demand for capital preservation-style products will have a number of effects on the financial markets:
 - Huge demand for zero-coupon bonds will keep the short end of bond curves supported despite the broad normalisation of interest rates. This prominent short-end support in the bond market would then also lead to steeper yield curves and a higher term premium in the fixed income markets.
 - Permanent demand for protection against volatility would make downside protection more expensive, while providing a plentiful supply of upside volatility. These factors would thus increase skewness in the implied volatility curve.
 - Guaranteed products are longer-term in nature, tying investors in for periods up to five years. This will place a premium on more liquid investments and raise the overall liquidity premium on investments.

Conclusion

None of the planned efforts to circumvent the distribution channel for financial products over the past decade led to significant changes in the way HNWI's prefer to interact with their asset managers. The turmoil following the market collapse of 2008 merely strengthened the relationship between advisor and client, rather than weakening it. The current economic landscape is filled with much uncertainty and hitherto unforeseen complications. This means that clients appreciate the analysis and objective inputs from their advisors more than ever before, and place a premium on wealth care and wealth preservation as opposed to mere asset management.

IFRS 13 Fair Value Measurement

What now?

More fair value guidelines?

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On 12 May 2011 the IASB issued IFRS 13 *Fair Value Measurement* which is applicable from 1 January 2013. This new standard redefines fair value and sets out a single framework for measuring fair value and requires disclosure of this fair value measurement. IFRS 13 does not determine when an asset, liability or an entity's own equity instrument is measured at fair value. Rather, the measurement and disclosure requirements of IFRS 13 apply when another IFRS requires or permits the item to be measured at fair value.

IFRS 13 was developed by both the International Accounting Standards Board (IASB) and the U.S. national standard-setter, the Financial Accounting Standards Board (FASB) as part of the ongoing convergence project.

The below definition of fair value is clear evidence of this combined project and those familiar with U.S. generally accepted accounting principles will recognise the wording. The new IFRS fair value definition is as follows:

“Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”



If you are an investment manager or fund director, you might be wondering how this new standard will affect you and will you be faced with more onerous valuation decisions. In fact, IFRS 13 will provide clearer and more market-focussed guidance which you will find more appropriately reflects your fund and its portfolio of investments.

IFRS 13 states that an entity must assess the following to arrive at an appropriate measure of fair value:

- Particular characteristics of the asset or liability
- For a non-financial asset, its highest and best use
- Principal (or most advantageous) market
- Assumptions market participants would use

So what does this new terminology mean and how will it affect your pricing methodologies and disclosures?

Under IAS 39, long held securities were required to be priced at their bid price and short held at their ask price. This was often in contradiction to the pricing policy as specified in a fund's prospectus. Fund prospectus' often specified the use of mid or closing prices. This gave rise to the onerous reconciliations comparing the pricing methodologies, the materiality assessments and the required disclosures. Under the new standard, gone is the conflict between the IFRS prescribed bid/ask pricing and the industry norm of the use of mid or closing prices.

IFRS 13 specifically states that if an asset and liability measured at fair value has a bid and an ask price, the price within the bid-ask spread that is most representative of fair value in the circumstances shall be used to measure fair value regardless of where the input is categorised in the fair value hierarchy. Whilst the use of bid and ask prices is permitted, it is no longer required. Similarly, IFRS 13 does not prevent the use of mid prices which will be seen as a positive development.

IFRS 13 provides guidance on the measurement of fair value of non-financial assets. It prescribes that the value assigned to an asset should be equal to the value of that asset which maximises its use. It takes in to account the use of the asset that is physically possible, legally permissible and financially feasible.

The principal market is described as the market with the greatest volume and level of activity for that asset or liability. In the absence of a principal market it will be the market in which the entity could achieve the most beneficial price for that asset or liability. These are more than likely to be the same as the market in which the entity normally transacts would be presumed to be the principal and most advantageous market. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs.

Description	Examples
Level 1: Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date	Quoted equities and bonds traded in active markets and exchange traded derivative products
Level 2: Inputs other than quoted market prices included with level 1 that are observable for the asset or liability either directly or indirectly.	Simple Over-The-Counter (OTC) derivative products priced using observable data, some FoF investments, certain bonds not traded on active markets
Level 3: Unobservable inputs for the asset or liability (no market data, not correlated with market data)	<ul style="list-style-type: none"> • Certain FoF investments with liquidity restrictions • Complex and/or long-dated derivatives • Manager/director valued investments

IFRS 13 also prescribes how to apply valuation techniques. An entity should use valuation techniques appropriate in the circumstances and for which sufficient data are available to measure fair value, maximising the use of relevant observable inputs and minimising the use of unobservable inputs. IFRS 13 describes three such valuation techniques:

- The market approach - uses prices and other relevant information generated by market transactions involving identical or comparable (similar) assets, liabilities, or a group of assets and liabilities (e.g. a business)
- The income approach - converts future amounts (cash flows or income and expenses) to a single current (discounted) amount, reflecting current market expectations about those future amounts
- The cost approach - reflects the amount that would be required currently to replace the service capacity of an asset (current replacement cost)

IFRS 7 introduced the fair value hierarchy. IFRS 13 now seeks to increase consistency and comparability in fair value measurements and related disclosures.



The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The table on the previous page lists examples of instrument types and where they fit in the hierarchy based on the observability of the inputs in to their measurement.

IFRS 13 provides guidance not previously given relating to which inputs might be observable which include the following:

- Exchange markets – if an instrument is traded on a say the New York or London stock exchange, a closing price is readily available and representative of fair value
- Dealer markets – dealers stand ready to trade and typically provide bid and ask prices rather than closing prices. OTC markets (where prices are publicly reported) are dealer markets
- Brokered markets – brokers attempt to match buyers with sellers but do not use their own capital to hold instruments for sale. The broker knows the prices bid and asked by the respective parties
- Principal to principal markets – in this instance the transaction is negotiated independently with no intermediary and therefore little information is known or made public

IFRS 13 also provides examples of level 2 and level 3 input such as:

- Receive-fixed, pay-variable interest rate swap based on the LIBOR swap rate i.e. a level 2 input would be the LIBOR swap rate if that rate is observable at commonly quoted intervals for substantially the full term of the swap
- Interest rate swap based on a level 3 input such as an adjusted mid-market consensus (non-binding) price developed from unobservable data

IFRS 13 also has additional disclosures requirements in respect of level 3 assets and liabilities. IFRS 13 requires quantitative disclosure of the unobservable inputs and assumptions used, a description of the valuation process in place and a discussion of the sensitivity of the fair value to changes in the unobservable inputs and inter-relationships between those inputs that magnify or mitigate the effect on measurement.

In general, IFRS 13 will not prove to be overly onerous or introduce increased requirements/disclosures. It is more sensible in its approach than the principles from predecessor standards and is more adhering to the real market



The Volcker Rule: banking and investment management M&A catalyst?

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The Volcker Rule, the section of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as the Dodd-Frank Act or Financial Regulatory Reform) which requires banking entities to curtail proprietary trading activities and investments in hedge funds and private equity funds subject to certain limited exceptions, is challenging the status quo and likely to create M&A opportunities in the financial services industry.

What is the Volcker Rule's potential impact on existing bank business operations? How might the Rule change the M&A and divestiture landscape? What leading practices in sell-side and buy-side due diligence should banking entities consider before engaging in an M&A transaction? What opportunities will the Rule present to the investment management industry, specifically stand-alone asset management firms? This article provides an overview of the Volcker Rule, its permitted/prohibited activities, and post-reform banking M&A expectations and opportunities.

The Volcker Rule encompasses a wide-ranging list of securities, financial instruments and transactions, and can be expanded by federal regulatory agencies when deemed necessary

Volcker Rule overview

Section 619 of the Dodd-Frank Act, referred to as the Volcker Rule (and named after the former Federal Reserve Board Chairman Paul A. Volcker), prohibits 'banking entities'¹ (banks) which benefit from 'federal insurance on customer deposits' or have access to the discount window² from performing two main activities:

- 1) engaging in proprietary trading
- 2) investing in or sponsoring hedge funds and private equity funds subject to certain exceptions

The purpose of these prohibitions is to separate federal support for the banking system from speculative investing with the firm's own capital, to minimise potential conflicts between banking entities and customers, and to reduce overall risk to the banking entity.

The Volcker Rule encompasses a wide-ranging list of securities, financial instruments and transactions, and can be expanded by federal regulatory agencies when deemed necessary. And while the prohibitions do not

explicitly apply to systemically significant non-banks, agencies can levy higher capital requirements and other limitations for the conduct of such activities.

Permitted and prohibited activities

To help ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation, the Volcker Rule permits banks to engage in certain trading-type activities that represent core banking functions.

The Volcker Rule also states that a banking entity may invest in or sponsor a hedge fund or private equity fund subject to their meeting of specific qualitative and quantitative restrictions³. Among the qualitative restrictions, the fund must be organised and offered only in connection with bona fide trust, fiduciary and investment advisory services, and only to customers⁴ of such services. The bank may not guarantee, assume or insure the obligations or performance of the fund, or share the same name as the fund (or a variation thereof). Finally, no director or employee of the banking entity may have an ownership interest in the fund unless he or she is directly engaged in providing services to the fund.

1 Defined as a firm that benefits from federal insurance on customer deposits (and/or has access to the discount window) under Section 619 (h) (1) of the Dodd-Frank Act

*2 Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, July 21, 2010.
<http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf>*

3 Other conditions include that the banking entity complies with the restrictions on affiliate transactions with any fund it sponsors consistent with Sections 23A and 23B of the Federal Reserve Act.

4 The Volcker Rule does not define the term 'customer'. Moreover, there are different statutory definitions of 'customer' in both banking and securities laws. The underlying nature of the customer relationship is something that it would be helpful to have clarified in a future rule-making



The key quantitative restriction is that a bank's investments must be *de minimis*. Specifically, they may not represent:

- 1) more than three percent of the total ownership interest of such a fund once one year has elapsed since its establishment (although during its one-year 'seeding period', the bank can provide up to 100% of the capital of the fund)
- 2) all aggregated investments of the banking entity in such funds may not represent more than 3% of the Tier 1 capital of the banking entity

In an 18 January 2011 study⁵ mandated under the Dodd-Frank Act, the Financial Stability Oversight Council (FSOC) stated that it 'strongly supports the robust implementation of the Volcker Rule.' It recommends that the U.S. regulatory agencies 'compel banking entities to develop and integrate into current compliance regimes a new, specifically-tailored program of policies, procedures and other controls designed to ensure adherence to the Volcker Rule and facilitate supervision'.

The FSOC study offers three guiding principles for the implementation of the Volcker Rule:

- 1) ensuring that the banking entities do not invest in or sponsor such funds as a way to circumvent the Volcker restrictions on proprietary trading
- 2) confine hedge fund and private equity fund activities of banking entities to customer-related services
- 3) eliminate incentives and opportunities for banks to bail out funds that they sponsor, advise, or have significant investment in

Similar to proprietary trading oversight, the FSOC study has expectations that banking entities will have a robust compliance monitoring programme around the Volcker Rule's restrictions on investments in and sponsorship of hedge funds and private equity funds that includes investment and risk oversight by the banking entity and senior management, public attestation of compliance by the CEO and engagement by the Board of Directors.

The federal agencies⁶ are required, no later than nine months after the completion of the FSOC study (which means that the final Rule should be issued in October 2011 at the latest), to adopt regulations by which to implement the Volcker Rule and must consider the recommendations of the FSOC in developing and adopting such regulations. The final effective date for the prohibitions and restrictions of the Volcker Rule is either 21 July 2012 or 12 months after the issuance of final Agency Rules.

Expectations for the financial services M&A market

The combined regulatory and legislative changes emanating from the Volcker Rule and other Dodd-Frank mandates, such as the potential loss of revenue streams from proprietary trading and fund sponsorship, are expected to compel many banks to revert to a 'back to basics' strategy.

⁵ 'Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds,' the Financial Stability Oversight Council, <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf>

⁶ The Fed, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), Securities Exchange Commission (SEC), and the Commodities Futures Trading Commission (CFTC)

The final effective date for the prohibitions and restrictions of the Volcker Rule is either 21 July 2012 or 12 months after the issuance of final Agency Rules

This would entail a refocusing by banks on the geographical markets, lines of business and customer segments in which they excel, and a conformation, winding down or selling of certain derivative, securities, trading and investment management operations, either because they have become impermissible activities or because they have had higher capital charges or operational requirements levied on them, such that they have become uneconomical for an institution.

As these mandates will likely lead to a substantial increase in regulatory compliance costs for all banks, this could have a dramatic impact on mid-sized banks struggling with higher operating costs, decreased revenue streams and higher capital requirements, driving substantial industry consolidation, as well as a growing number of acquisitions by banking institutions in the \$10-\$50 billion range, to take advantage of scale and synergies. It is yet unknown how quickly these consolidations and acquisitions will take place and how stringently the federal agencies will implement the Volcker Rule.

Likely scenarios the banking industry could expect to see as a result of pending rules include:

- Resolution of proprietary trading divisions by large institutions. Where these divisions currently make a significant contribution to profits, the carve-out and sale may be held off until as late as possible as banks try to bolster core earnings. Alternatively, several banking entities are deciding to shutter their trading operation rather than sell it, as the capital the business requires is too high to tempt an investor to buy it.

As a result, some top bank trading desk employees are migrating to broker-dealer and asset management firms, recasting themselves as fund managers. The launch of new hedge funds has spiked thus far in 2011. This migration may provide future revenue streams for banks that refer customers to these newly independent traders and their funds

- Divestiture of non-core divisions that generate consistent revenue streams (e.g. wealth management revenues and fund management fees) could impact the volatility of earnings depending on the business being sold or closed. While industry earnings and top-line growth remain weak, there may be a tendency to take hits on poorly performing units/divisions to get the bad news out of the way. A bank may have to sell at a loss in a down market to clean up its balance sheet and retrieve some capital or double down on the businesses it wants to retain
- Investment managers and securities firms using Volcker Rule-driven divestitures as a transformative event to remould their firm via greater scale or product line enhancement

Volcker Rule impacts on the M&A process

Banking entities should expect Volcker Rule directives to have considerable impact on the industry's M&A process. In a transaction's strategy phase, for example, a bank will need to determine what stripping away cash-generating businesses (e.g. proprietary trading desks/hedge funds) could do to its operating model going forward: How will Volcker Rule compliance impact my product and services platform, especially if I decide to refocus on pure-play banking? Should I acquire a bank with a strong origination platform or stable, low-cost deposit base to improve my net interest margins? Should I look for targets that expand my geographic footprint or diversify my customer mix? Should I consider a merger in order to lower costs or gain economies of scale? What value will I get from a deal that can help me retain my best customers and employees?

The target screening process should also factor in Volcker Rule compliance issues: if I am looking to buy a bank, is it getting a meaningful percentage of its revenue from hedge funds or proprietary trading?



If so, that will likely impact the overall value of the organisation as those businesses may have to be curtailed, shuttered or shed. Of the bank's remaining assets, what am I really buying; is it geographical markets I want to be in, a customer base I want to capture, different products and services than I currently have (e.g. mortgages) or other strategic rationale?

Transaction execution and integration

Volcker Rule restrictions will likely generate more scrutiny of M&A Transition Services Agreements (TSAs) as businesses are unwound and acquired. Both buyers and sellers will need to address fundamental questions and issues during the TSA development process.

A banking entity that is carving out an asset such as a trading desk should identify any retained costs from the organisation being sold (e.g. IT infrastructure, software, support personnel) and determine whether it will have to continue supporting those costs or be

able to shed them. Among other issues: are there any existing or ongoing litigation or regulatory actions with the asset being divested that may cause problems in the future? Does the carved-out function currently perform any activities that will still be needed, such as cash management? Does the sale involve any intellectual property or proprietary software to which the seller may need future access? How can I effectively manage the transfer of software vendor or service provider contracts after the change of control? Are we giving the buyer all of the historical emails, data, files and records it will need to support the business going forward?

For the acquiring company, understanding the asset's stand-alone cost basis will be important, as will answering operational questions, such as: will my agreement require me to use the seller's IT systems? How long will I have access to the seller's IT support services (e.g. help desk, data back-up, security systems)?

If the seller no longer has a relationship with the customers of its carved-out business, how will funds be distributed? If I buy a hedge fund business and the terms of that business allow customers to withdraw assets when there is a change in control, how can I implement an effective customer retention strategy or structure payment terms to protect myself on the downside? In general, the transition can be more difficult for the buyer than the seller: the buyer needs to establish an environment to support the business going forward and think about what its needs may be down the road. If there is a legal issue or regulatory request, for example, a buyer has considerably less leverage to get the required data from the seller a year after the transaction occurs than during the TSA process.

Bank money managers who intend to use the spin-off to start their own firm may face fundamental, and costly, infrastructure challenges. Among potential questions: will we be able to take our performance track record, models and other supporting documentation to the new firm? Do we have the trading support structure we need, order management and execution systems, market data subscriptions, portfolio accounting tools? Newly established private fund advisors with limited infrastructure may decide to outsource non-investment functions to service providers so they can focus on core competencies of generating investment returns, managing investment risk and raising capital⁷.

Among functions these service providers may perform are fund administration, financial accounting and reporting, valuation, asset gathering, investor relations, corporate services, business continuity, technology support or application hosting, disaster recovery planning, tax and regulatory compliance services. Because these functions can be numerous and extensive, the fund advisor should develop a robust framework for selecting and monitoring the service providers⁸.

⁷ *Selection and oversight of service providers to private fund advisors: Establishing a sound plan for success*, Deloitte, 2011

⁸ *Ibid*

Closing thoughts

As the financial services market responds to the rapidly evolving regulatory environment the difference between a prepared or unprepared seller can significantly impact the price, terms and execution of a divestiture. An unprepared seller may experience delays and complications that could scuttle a potential deal and negatively impact the long-term success of its remaining core business, as well as risk running afoul of the Volcker Rule and other Dodd-Frank regulations. In contrast, a prepared seller may be better positioned to accelerate the transaction close, maximise the deal value, facilitate regulatory compliance and retain focus on the strategic direction for the remaining core business.

Similarly, a prepared buyer can avoid a franchise-damaging acquisition and take advantage of this transformative regulatory change to improve its long-term business prospects. An unprepared buyer may quickly lose the value of the investment professionals and their track record in a highly mobile and competitive, human-capital intensive business. This is a watershed moment in the evolution of the financial services industry, especially in relation to the unprecedented opportunity for investment managers to transform the breadth and depth of their institutions and for banks to return to core strategies; so proper readiness and preparation today can mean a significantly better tomorrow.

AIFMD

...when the dust

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It is one of the paradigms of the investment industry, that regulation inevitably trails the market, as innovation will always, almost by definition, be ahead of the regulation intended to 'control' it. And never has this been more true than in the realm of alternative investments. It is in this context that the European Commission's AIFMD (Alternative Investment Managers Directive) enters the fray.

Seldom has legislation attracted so much interest, debate, heart-searching and misconception, as well as an almost biblical rending of garments and gnashing of teeth. It has all the elements of a Jacobean drama, with calls for accountability, punishment of the guilty, the vilification of the industry as solely responsible for the world's financial woes, lobby groups, public dissent and much else. And lurking in the background is the shadow of those two horsemen of the Financial Apocalypse: Madoff and Lehman.

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- Seldom has legislation attracted so much interest, debate, heart-searching and misconception, as well as an almost biblical rending of garments and gnashing of teeth

has settled...

In fairness the reflection started in 2006, when the European Commission and large parts of the industry believed that the alternative investment field could benefit from a pan-European regulatory framework similar to that governing UCITS. It is also fair to remark that, however vociferous the industry later became, it missed the opportunity to self-regulate to any significant extent, one might argue to any extent at all, and consequently attracted the attention of the regulator.

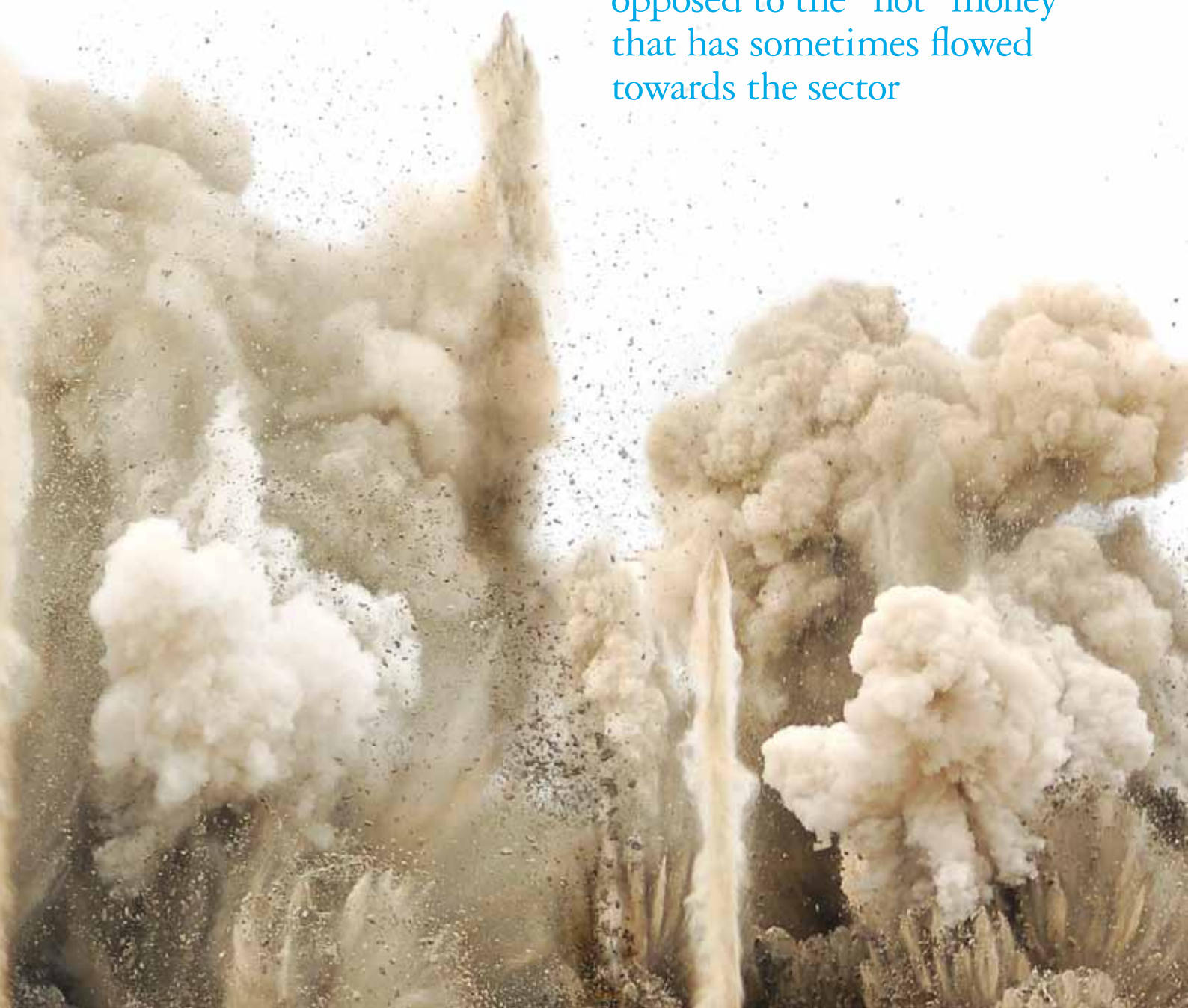
But what started as a reflection turned into a maelstrom with the events of 2008 and influences other than calm reason came to bear as governments, regulators and market participants alike realized how truly close to the brink they had been... or did not, as the case may be. It is arguable that, even today, some areas of government have yet to understand where the real problems lie or what the potential remedies may be. (Amid this flurry of reform, has anyone noticed significant change within national regulators, the watchdogs who were supposed to ensure that markets could not imperil the national well-being? A noted European parliamentarian, closely involved in the AIFMD process, famously remarked that 'we are still in the same system as in 2008'.)

AIFMD sets out with two clear intentions: to introduce standards of transparency, prudence and customer protection, and to equip regulators and governments alike with the tools to monitor and potentially control or alleviate the negative impacts that alternative investment funds and their managers may have on world financial markets. These tools take the form of a glorified 'circuit-breaker', akin to measures introduced in the U.S. to curb the impact of programme trading.

In both of these objectives it will no doubt succeed. The question is, at what cost? Will these goals be achieved at the cost of driving away the very activity they are designed to regulate? And would it matter if it did?

The last of these questions is perhaps the easiest to answer. The search for yield is a constant. The regularity of yield expectations de-correlated from market trends is what spurred the creation of the alternatives sector in the first place – what with the emergence of hedge funds, which put the investor at the heart of the trading strategy rather than viewing them as one more or less active party to an intermediated trade, and in the emergence of private equity and, to some extent, real estate products that sought to capture the potential for above-average non-organic growth by accumulating the flexibility of entrepreneurship and proximity development into a defined asset class. It was confirmed when the growth of the sector was reinforced in the wake of the dot-com bubble. And it is true today...

The real challenge is separating the innovators from the imitators, and then allowing them access to reasonably stable funding as opposed to the “hot” money that has sometimes flowed towards the sector



When one considers the implications of the global funding shortfall that looms over the pensions market – a shortfall that on a net present value basis takes debt-to-GDP ratios in the developed world up to an implied 300% or more. When one considers the time frame in which that deficit must be made good or face the consequences of permanently reversing the balance between the developed and developing world to the catastrophic detriment of both, and when one evaluates the available non-pension assets that might be mobilised to partially close the gap, and the savings capacity both real and potential, simply stated, long-only positions offer an insufficient return with which to meet the requirement, and this is certainly true of long-only positions in the traditional 'safe' asset classes that have seen the majority of pension investment in the past. If one is looking for return, one is inevitably looking at alternatives.

So those potential providers of return concerned by the Directive, the alternative investment managers, are in fact at the heart of the solution. And the Directive comes at a time of change, for the alternative investments fund industry itself is evolving following the impacts and effects of 2008.

On the one hand, hedge funds seem to have lost a little of their shine, and on the other, private equity and its first cousin, real estate, have started to shed their niche status to be understood as an asset class with a significant role to play in economic infrastructure.

Both have a tarnished image in the eyes of the general public, regulators and, to some extent, investors. Certainly, hedge funds have in some cases disappointed, and the implications implicit in their structures that resulted in 'gating', 'side pockets' and other reactions to potentially foreseeable but unfortunately unforeseen circumstances have somewhat dented their reputation. By their very nature, hedge funds are innovative; as long as there is a viable trading opportunity in markets and whatever its underlying economic driver, there is a potential hedge fund. The real challenge is separating the innovators from the imitators, and then allowing them access to reasonably stable funding as opposed to the 'hot' money that has sometimes flowed towards the sector.

While private equity has managed to attract public awareness for the wrong reasons, perceptions of asset stripping (as echoed in the Directive itself that are, sad to say, the only provisions formulated with Private Equity specifically in mind) and highly publicised if not always positive, press coverage for the role played in managing certain companies that have come into the public eye in, for example, the healthcare and retirement sector – the omnipresence of private equity ventures has stayed beyond the general scope of public consciousness. And yet if there is one sector that touches all areas of everyday life, it is private equity. One might be forgiven for wondering how many politicians, regulators and others involved in the AIFMD drafting process would realise that names they recognise from everyday life are owned or controlled by private equity structures. Insurance companies were among the first to recognise the potential for non-organic growth in the sector offering the much-sought-after and consistent returns, and that is itself a sector noted for a certain conservatism.

But the Directive does pose problems for the industry. It poses problems from its one-size-fits-all approach. It remains a hedge fund directive, as can be readily ascertained from even a cursory examination, yet it sets out to regulate everything in the world of unitised funds 'that is not a UCITS'.



In this respect, measures that may make sense for hedge funds, pose significant problems of either logistics or pure interpretation for private equity and real estate.

There is a delicate balance to be struck between achieving the appropriate level of transparency to protect investors, to giving the relevant authorities with the tools necessary to succeed in their mission and to fulfill their obligations of safeguarding the public good (even if at the same time one might hope for greater accountability and understanding of the tasks they set out to address and less regard for political posturing and national interest) and still promoting the growth of a sector that has the potential to play a key role in meeting global challenges.

A significant risk persists that over-regulation could cause the sector to break up. Indeed, there is already a palpable reluctance to welcome the measures pertaining to remuneration disclosure and limitation. The Directive introduces the now familiar concept of at least a significant proportion of variable remuneration being paid in units of the fund managed. The articles concerning both this and the disclosure of remuneration are likely to prove unpopular with many managers, especially in the Anglo-Saxon world. In some cases, the measures have caused respected and known figures in the sector to withdraw and concentrate entirely on managing their own investments.

The blow here is somewhat softened by prior legislation in the same vein towards remuneration in the banking sector, and a recognition that such disclosure is inevitable. Where the conclusion becomes less sustainable is that it reflects political thinking rather than economic reality, a belief that remuneration beyond a certain level is somehow immoral. Without taking a stance on such a bedeviled issue, it is evident that such reasoning – similar to reflections on corporate governance which suggest that the interests of all 'stakeholders' are of equal relevance and hence to be considered as those of shareholders (is a competitor not a 'stakeholder' to some degree?) moves into a realm that goes beyond market efficiency or ensuring the development of the internal market. (And here it should be remembered that this is the purpose of European directives.) Rather it establishes a halfway house towards full political integration, that is not mirrored by fiscal or national integration, and broaches a much wider debate than the simple ethics of alternative managers' pay.

For it should also be remembered that the markets will always function in accordance with supply and demand; if a product is viable and successful, irrespective of where it may be domiciled, irrespective of the degree of regulation that may surround it, 'smart' money will find its way to that product; and then the regulator will have succeeded simply in limiting the choice of investments available to the less savvy, less mobile, less well-informed segments of the investing community that are the original focus of its intentions.

The sector needs the yield opportunities afforded by alternatives, as well as the sophistication and innovation of this market, and it needs it for all this to be generally accessible and not to be the preserve of an elite few. And to this end, the carrot that is offered by AIFMD must be at least as compelling as the obligations are onerous.

And that carrot is, of course, distribution.

Because the opportunity is there. Twenty-five years ago one would have been hard-pressed to make a case for a regulated onshore product (such as a UCITS) supplanting unregulated products (such as Cayman, Bahamas and BVI – domiciled unregulated funds) in supplying the needs of the offshore and cross-border market. But that is precisely what has happened.

The paradigm is simple: submit to the constraints introduced by AIFMD and in return gain free access to pools of investible income that can transform the sector. And the means? The creation of a standard of acceptable regulation that can be taken as a mark of quality worldwide while allowing sufficient flexibility to encourage rather than stifle intelligent innovation, and the opening of markets via distribution arrangements that, in reducing the costs and even removing insurmountable barriers to market entry, can compensate adequately and outweigh the costs implicit in conformity.

And nowhere is that paradigm more true than in the implied reciprocity that AIFMD holds out to non-EU AIFM. It has been argued that AIFMD does not offer reciprocity, and strictly speaking this is true. The Directive extends the possibility of opening up European markets to non-EU managers (and hence their products) in a phased manner, with even in the more distant future the possibility, still to be confirmed, of the extension of the passport to non-EU managers for non-EU products.

Long before that, however, the Directive opens up new possibilities with the mechanism of the Reference Member State, (the means by which a non-EU AIFM and therefore AIF can voluntarily submit to EU regulation and in return obtain unrestricted access to EU markets).

The paradigm is simple: submit to the constraints introduced by AIFMD and in return gain free access to pools of investible income that can transform the sector

Some of the a priori's around distribution are also worth examining. In some respects it is true that this Directive pertains to alternatives, which, by definition, are accessible to a smaller segment of the investing population than pure retail products. It is also worth pointing out that AIFMD covers all non-UCITS irrespective of the target distribution market. The theme throughout the text on Professional or Sophisticated Investors, refers only to the distribution and passport provisions; where AIF are available to the retail market, AIFMD applies.

Furthermore, Article 43 specifically levels the playing field for retail distribution. Where a member state elects to make alternative products available to retail investors, it is at total liberty to set additional standards and conditions beyond those specified by AIFMD. However, it may not discriminate on the basis of domicile within the EU. Therefore, if an AIF from another member state meets the criteria for distribution to domestic retail investors, it can have access to that market.



It could well be that the greatest long-term beneficiary of the Directive will prove to be probably its most vociferous and virulent opponent – private equity. For it is in the field of private equity that a manager who is close to and understands his home market has been most limited in his ability to attract foreign capital. AIFMD offers the mechanism to rectify that, thereby also potentially increasing the scope and breadth of the choice offered to investors in the asset class, thereby promoting on the one hand greater competition, to the inevitable benefit of investors, and making available capital on the other to a sector that generates investible income itself.

A former British prime minister, Edward Heath, coined the phrase, the 'unacceptable face of capitalism'. In a sense the whole question of perception, vilification and contention is very similar to the paradox that in regulating financial markets, politics and perceptions will inevitably play an important role in the equation, as the road to success lies through distribution, and extended distribution means globalisation, which will inevitably bring distribution into contact with varying spectra of political opinion and circumstances. For one may think what one will of capitalism or any other system or ideology; in the modern world, differing ideas will inevitably co-exist; the growth of Islamic finance and the use of non-Islamic vehicles to promote it being just one spectacular example of success in this climate of diversity.

And for investment products to be able to flourish in this world of co-existence they need to be universally acceptable with recognised standards. AIFMD can provide those standards.

And if AIFMD can become the 'acceptable face' of alternatives, then it opens the way for the development of a brand for alternative investments, which can lay to rest the ghost of the poor image with which the sector has been beset and allow alternative investments to play the role they are capable of playing in the development of international financial markets.

The wager, and one might be forgiven for questioning if it is intentional or fortuitous; there is little in any of the preparatory work, save some almost off-hand recognition in different working groups of the dangers and the implications, that such considerations weighed heavily or even weighed at all in the reflections that brought the current text to fruition, and certainly not to the extent of anything remotely approaching the attention afforded to pandering to the political gallery, following national interest or giving substance to preconception without validation, is simple. The wager is therefore significant. The market must shoulder the burden of increased transparency, regulation and cost; in so doing it may achieve a global brand and deepened distribution akin to that seen in UCITS. One is assured, the other speculative. Time and vision will tell. But one thing is certain: to meet the challenges of creating the necessary levels of income into the next decade to avoid whole sections of the world's population from falling

into the category of the impoverished middle aged and elderly, developed and developing economies alike will need the flexibility of every asset combination and the constancy of de-correlation alike. The 'regulator' would be well advised to ponder this in finalising the implementation of his measures and in assessing the success of his endeavours.

It is said that 'there is no first mover advantage when you are in a minefield', and one may be forgiven for thinking that 'a minefield' is an apt description for AIFMD for all its conflicting influences, impacts and implications. Yet the opportunities and the scope alone are impressive. Seldom has legislation harbored such a potentially far-reaching impact, and perhaps never before have the advantages been so great nor the need so pressing to understand not merely the text, but the reasoning and dimensions of the Directive. Never has the value been more apparent of professional services that have the capacity and the skill to analyse, interpret, advise and implement.

The high grade ore is there; it will require expertise to identify and extract it

Why service organisation control reports matter in a Solvency II context

ISAE3402 (replacing SAS70) reports: a powerful tool to address Solvency II reporting and data quality constraints in an outsourced asset management environment

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Solvency II: what is it all about?

Solvency II is the most far-reaching change to the framework governing insurance companies in the European Union in over 20 years, impacting the tools, organisation and processes involved in risk management and regulatory reporting. It aims at implementing new solvency requirements taking into account an economic approach for risks quantification, as well as a supervisory review process to be consistently applied across all member states. It is expected to be implemented by 2012, with a possible transition period running into 2013.

The Solvency II regime offers incentives—in the form of capital requirements relief—to implement sound risk management and internal control systems. As in Basel II for the banking institutions, the regime has a three-pillar structure with each pillar governing a different aspect of the Solvency II requirements and approach:

- Pillar 1 Quantitative Requirements. Pillar 1 of the system includes the calculation of technical provisions, the rules relating to the calculation of the solvency capital requirements and investment management (Minimum Capital Requirement (MCR); Solvency Capital Requirement (SCR))
- Pillar 2 Supervisory Review. Pillar 2 deals with qualitative elements, defining both the principles of risk management systems and governance as well as the supervisory review. It incentivises insurers to develop and implement internal risk management processes, and carry out an Own Risk and Solvency Assessment (ORSA) against SCR calculations to determine their own capital requirement against which they manage the business

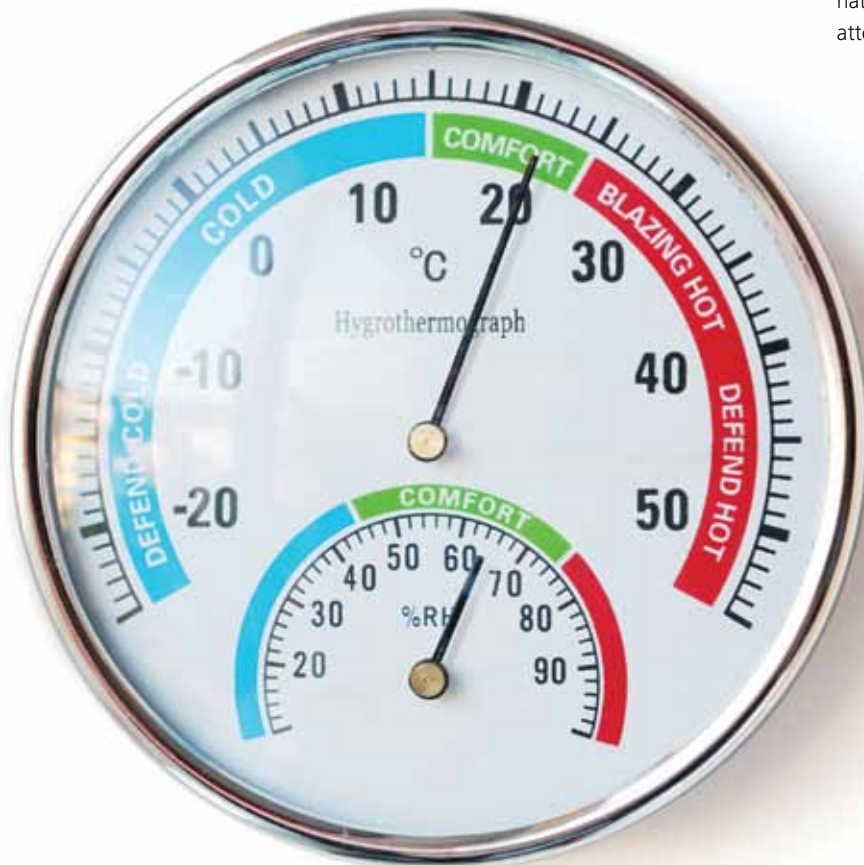
- Pillar 3 Market Discipline. Pillar 3 deals with market transparency and discipline in the insurance industry, ensuring that organisations disclose key information that is relevant to the market and supervisory authority. It will aim to harmonise reporting to supervisors, including the information need by supervisors to perform their functions and information not previously in the public domain.

The expectations regarding the reporting framework are high and assume that insurance companies are able to ensure proper reliability thereof. Indeed, across the three pillars, insurers are required to ensure at each stage that the calculations, underlying assumptions and data supporting the reporting process are sufficiently robust and reliable, and are all historically retrievable. Under Solvency II, the requirements in terms of data quality and reporting frequency bring another level of complexity to this already difficult regulatory listing.

The data (market, holdings, transactions, etc.) form the elementary information feeding the economic balance sheet and technical calculation supporting the production of reporting, whether regulatory or managerial.

A robust and 'risk proof' process and workflow has to be defined and implemented by insurance companies. This is particularly emphasised in the Article on Technical Provisions (Former Consultation Paper 43, Art. 121), Publication and Reporting (Former Consultation Paper 58, Art. 35, 50, 52, 55), Governance (Former Consultation Paper 33), Internal Models (Former Consultation Paper 37, Former Consultation Paper 80, Art. 231).

The Former Consultation Paper 43, which originally deals with the calculation of technical provisions, requires the management of data quality throughout their life cycle, as well as from an historical view point. Therefore, the ability of a company to prove the reliability of their reporting on a real time basis, regardless of the time or nature of the calculation, is a focus area attracting the attention of the regulators.



The key aspects of data quality supporting the reporting process and calculation are developed as principles under Solvency II texts, especially the Former CP43, and include the following:

- **Completeness of data:** data should exist present sufficient granularity and historisation as regards calculations; it should also cover material information as regards the activity
- **Accuracy of data:** data should be free from material mistakes, errors and omissions; it should also be consistent over time
- **Appropriateness of data:** data should be suitable for the calculations and relevant to the risks and liabilities portfolio.

These three 'principle-based' criteria require additional rules such as:

- **Data integrity:** this relates to the proof that historical data used for the calculation or the reporting are properly archived, with a guarantee that they were not altered or destroyed afterwards, e.g. ensuring at all times that the MCR or SCR could be calculated again using the same hypothesis and data
- **Availability of data:** this relates to the manner in which data are extracted and used when required by users and quality review to meet the objective of their use. This section includes the notion of information system efficiency, as the data retrieval process must be completed in a reasonable amount of time, i.e. efficiently
- **Auditability and traceability:** as mentioned above, the requirement regarding the ability of a company to re-perform the calculation and reporting of past periods will require all information or data to be properly archived and changes to be tracked. For example, this could involve recording the reference and origin of the data (for example: euro-dollar exchange rate as at day X, from Bloomberg, on the fixing of the day X), with a record also of any change to this data, by whom, what was the historical data, etc.)

- **Compliance with the regulatory requirements** applicable to the company, as well as the internal rules defined by the company when applicable
- **Information System Security** (physical as well as logical security): this relates to the way in which the systems environment is secured and accessed, modification and archiving are both secured as well in order to ensure non alterability and reliability

Hence, the challenge of preparing for and implementing Solvency II calls for a multi-disciplinary approach. This could prove tricky in the investment management industry as most insurance companies delegate all or some of the management of their assets to third party asset managers.

Introduction to SAS N°70, ISAE3402 or SSAE16 standards

The already well-known SAS 70 Standard (Statements on Auditing Standard No. 70, Service Organisations) is used by third-party service providers to report on their governance and control framework. The report aims to provide reasonable assurance to the user of the report that the service provider's controls are suitably designed and implemented effectively to meet a set of control objectives relating to processes and information systems covered by the attestation work performed by an external auditor.

As of 15 June 2011, SAS 70 is to be replaced by two new standards, ISAE 3402 (International Standard on Assurance Engagements 3402) and SSAE 16 (Statement on Standards for Attestation Engagements 16), which are already widely used in the financial services industry to build trust and confidence in outsourced relationships.

More specifically, in the investment management industry in Europe, the use of service organisation control reports is more prevalent in the asset servicing segment (custody, transfer agency and fund administration), but is becoming increasingly common in the asset management segment and will obviously become a must-have if not at least a competitive disadvantage for asset managers unable to provide this type of report.

Why ISAE3402 could be a powerful tool in view of meeting Solvency 2 requirements

With the strong requirements enforced by the Solvency II regulation, organisations providing services to insurance companies for clients may find in the ISAE 3402 or SSAE16 service organisation control reports a useful tool to demonstrate the robustness of controls addressing operations and reporting processes outsourced to them by insurance companies.

Most European insurance companies delegate all or part of the management of the assets side of their balance sheet to third-party asset managers, through mandates, dedicated funds, or open-ended funds for instance. For their policyholders, they can also sell Unit Linked contracts (based on the value of units). All these components can impact the calculation of the Solvency II ratios (MCR and SCR).

It is easy to understand that the delegation of asset management and reliance on the holding records and valuations reported by custodians and fund administrators could turn into a nightmare for insurance companies, facing important stakes in terms of their own liability management.

In this context, the standards ISAE3402 or SSAE16 bring the strength of a modern framework of assurance standards, complemented by the transparency and completeness provided by an extensive report issued by a service auditor. In addition, the flexibility of these tools is ensured because the scope of the processes and activities covered is tailored to the user needs and to the assessment of the risks attached to business processes or information systems, and how they can impact the end user of the attestation report. In addition, the methodologies used by the audit firms are common, as they are enforced by international bodies. This can facilitate comparisons between companies belonging to the same industry. These methodologies, especially concerning the testing of controls, are strong. Indeed, for Type 2 reports, in which the effectiveness of the controls in place are tested for a period of six or 12 months, for example, any deficiency identified during the tests will be included in the service auditor report

Most European insurance companies delegate all or part of the management of the assets side of their balance sheet to third-party asset managers, through mandates, dedicated funds, or open-ended funds for instance



(SAR) and finally released to the client who requested the report. This puts strong pressure on service providers to ensure they have proper, robust and provable ways to operate their controls, throughout their business and IT processes.

Going back to the example of Solvency II, an insurance company could for instance request an SAR covering the reporting they receive on their holdings, the mark-to-mark or mark-to-model thereof, NAV calculations, value at risk (hereafter 'VaR') calculations, etc. Then the processes implemented and the output thereof as well as the controls related to the data quality (completeness, accuracy, traceability, auditability, integrity, etc.) will be checked on a regular basis by external parties. Then, as part of their Solvency Capital Requirement (hereafter 'SCR') and Minimum Capital Requirement (hereafter 'MCR'), but also the own risk and solvency assessment (hereafter 'ORSA'), insurers could rely on a tangible report that they can assess and review with the service providers, should they be asset managers, custodians or fund administrators.

Opportunities for the asset management industry

What will be the face of the insurance industry and its relationship going forward? As a consequence of the financial crisis and the reinforced regulation framework, insurance companies are searching for the most efficient model to manage the asset side of their balance sheets. The current models in Europe, mainly developed around outsourcing to asset managers, imply that insurers have to ensure that the information provided by these service providers is communicated in an accurate, complete and timely manner to them. Another model, which is to develop or re-insource their own asset management (and related activities) capabilities, could lead to huge investments. A combination of both is more likely to occur.

Asset managers, custodians and funds administrators have already anticipated these new constraints and are developing specific 'Solvency II'-proof products. In this area, ISAE3402 or SSAE16 reports (replacing SAS70 reports) could play a significant role.



Illustration on technical provisions – CP 43

Illustration on regulatory requirements (Former CP 43)	Data definition	Data quality assessment	Management and resolution of incidents	Monitoring of data quality
Governance framework around data quality	<ul style="list-style-type: none"> - Identification of needs - Detailed description - Level of granularity, specifications 	<ul style="list-style-type: none"> - Completeness, accuracy of data - Integrity, traceability, auditability of data 	<ul style="list-style-type: none"> - Continuous improvement in the data quality process (information collection, and archiving) - Capability to maintain a database, with historical data, ensuring integrity and inalterability 	<ul style="list-style-type: none"> - Regular/periodic review of the data quality - Regular review of the process and workflow implemented, in terms of quality, reliability and timeliness of reports and calculations
ISAE 3402 – Type 1	✓	✗	✗	✗
ISAE 3402 – Type 2	✓	✓	✓	✓
	<ul style="list-style-type: none"> - The list of requirements is formalised generally using contracts or service level agreements - The level of service is then put in the scope of the service auditor report 	<ul style="list-style-type: none"> - The completeness, accuracy, traceability, etc. are covered by the control objectives and control activities reported and tested in the service auditor report 	<ul style="list-style-type: none"> - The monitoring processes, governance and identification of risks and errors are included in the service auditor report and communicated to clients 	<ul style="list-style-type: none"> - The operating effectiveness tests of the controls is tested by an external auditor and any exception is reported in the service auditor report

As a consequence of the financial crisis and the reinforced regulation framework, insurance companies are searching for the most efficient model to manage the asset side of their balance sheets



Reforming the Spanish criminal code: where corporate accountability matters

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Summary: New reforms to the Spanish Criminal Code came into force on 23 December 2010, a landmark move towards tightening corporate accountability with regard to the actions of directors and employees. The impact of this reform on the financial sector will be substantial, as companies scuffle to implement better governance frameworks and analyse their business for potential risks.

New reforms to the Spanish Criminal Code came into force on 23 December 2010, a landmark move towards tightening corporate accountability with regard to the actions of directors and employees. For the first time in Spanish history, companies are now criminally liable for the offences committed by their directors or employees in the discharge of their duties, alongside the individual in question. A significant development resulting from this reform is that preventive measures and adequate controls are now a critical defence to any potential criminal proceedings, which is not so dissimilar to the recent UK Bribery Act 2010.

The impact of this reform on the financial sector will be substantial, as companies scuffle to implement better governance frameworks and analyse their business for potential risks.

On a positive note, these measures to increase corporate accountability reflect the fact that Spanish companies and the country's government are recognising the threats to corporate reputation and fair market prevailing in their market. The reform is a step towards levelling the playing field of the Spanish approach in governing corporate behaviour vis-à-vis its European neighbours. In the wake of the global financial crisis, the reform will go a long way towards instilling confidence in the Spanish market.

Key features of the reform

Article 31.bis of the Criminal Code now provides for the criminal liability of the company:

- For offences committed in the name or on the account of the company, or for its benefit, by an individual who is authorised to act on the entity's behalf
- For offences committed where there has been inadequate control over an individual who has authority to act on the company's behalf, which results in the criminal activity

For the first time in Spanish history, companies are now criminally liable for the offences committed by their directors or employees in the discharge of their duties, alongside the individual in question

In the case of offence, the company and individual(s) will be charged with criminal liability and be subject to penalties such as: the dissolution of the company, suspension of its activities or closure of business premises and establishments for a maximum of five years, permanent or temporary prohibition from engaging in the business activities prior to the offence, disqualification from receipt of grants or public aid, public contracts and tax or social security benefits and incentives, punitive fines, and administration by the court for a maximum of five years.

The investigating judge may order the temporary closure of the business premises or establishments, suspend business activities and impose court administration as a provisional remedy during the investigation of the case.

Furthermore, in line with the UK Bribery Act 2010, the bribery of foreign public officials will also be subject to the Criminal Code rulings. This occurs when there is an offer, promise or grant of benefit in return for a favour for the company or third party and includes agents and associates of public officials. Penalties for this offence may include imprisonment of up to six years and fines.



Corporate defence model example

Principle characteristics of the corporate defence model which may be effective in practice:

- Existence of an effective control environment: code of conduct, corporate defence manual and specific controls in each area of the company
- Appropriate documentation of implemented controls (which can also serve as evidence in case of court proceedings)
- Internal review of compliance with the code of conduct
- Disciplinary provision and action in case of non-compliance
- Appropriate communication of the code of conduct to employees
- Compulsory employee training courses (online or in person) on the prevention of criminal risks

To sum up, important penalties may be imposed on companies as a result of a court proceeding which may significantly affect not only their economic situation, but also their ability to carry on their business, alongside having a negative impact on the company's reputation as a result of being charged with a criminal offence.

Corporate defence – action required

With standards on the UK and Spanish markets converging, preventive criminal control measures are now essential to prevent the criminal liability of the company or, in the event of being charged, to minimise penalties by providing evidence of adequate controls and diligence exerted by the company.

In a nutshell, corporate defence is an analysis of the criminal risks that could potentially be detrimental to the company, which lead to subsequent implementation of measures to minimise risks and provide evidence of adequate controls exerted over employees and management. This, in turn, will help provide appropriate defences should a court proceeding ensue in Spain. Similar to the UK Financial Services Authority's (FSA) Business Principle 3, the company is responsible for organising and controlling its affairs responsibly and effectively, with adequate risk management systems.

The objective of these measures is to analyse and locate gaps in the company's functions in order to identify potential offences before they are committed, implement protocols to protect the company from potential liabilities, protect the company's reputation, and increase transparency and cooperation with any investigating authorities. As it is not possible for any single person to know of all business activities, a robust corporate defence model will help feed information from many points to ensure that corrective or preventive action can be taken as soon as the risk has been identified.





The various European countries have chosen different solutions for the same problem: corporate criminal liability. Austria, Belgium, Denmark, Slovenia, France, Finland, Holland, Portugal and Sweden have included corporate criminal liability in their Criminal Codes. However, other countries such as Germany and Italy maintain an administrative system (with considerable fines) in order to punish misconduct by corporations. In this respect, it will be necessary to adapt the corporate defense model to the existing distinctions among the various European criminal regulations.







Management companies and other financial entities operating in Spain

The change to the Spanish Criminal Code creates a need for tighter internal corporate governance rules in management companies and other financial institutions in Spain. Spanish branches or affiliates' internal codes and policies shall be reviewed to ensure that they are sufficient in terms of preventing criminal liability. After the reform, tighter controls will not only protect the reputation of the management companies' business, but it will also prevent criminal liability and encourage a more cooperative and ethical company culture.

For an outline of the main criminal offences covered by the reform and that may have an impact on management companies and financial institutions, please refer to the table below.

Criminal offences	Examples
Money laundering	This offence may be committed unintentionally by neglecting the obligations established in the Prevention of Money Laundering Law
Corruption and bribery	Corruption or bribery (including intent) of authorities or public officials, including foreign public officials
Crimes against the public treasury	Tax offences due to intentional acts or omission, fraudulent obtainment of grants, etc.
Criminal insolvencies	Dealings in assets with a view to defrauding creditors, preinsolvency offences, etc.
Market abuse offences	The penalties for using insider information have been increased and spreading rumours of false information for the purpose of obtaining a benefit on the share price of certain securities is punishable
Property crimes	All types of fraud
Offences relating to the market and consumers	The company may be affected by the disclosure of secrets or by intellectual and industrial property offences
Corruption among private individuals	A new offence is created whereby the granting/offer of advantages to private individuals contrary to the obligations relating to the purchase or sale of goods or the arrangement of professional services is punishable

UCITS IV implementation status*

Country	Official languages	Transposed into local law	Advancement status	KIID language	Certified translations	Notification procedure
 AUT	German	YES	The Bundesrat voted without objection on the decision of the Nationalrat to adopt UCITS IV into national law. The new UCITS IV law will be applicable from 1 September 2011.	German	NO	All documents can be submitted to the FMA in either English or German. Only the Simplified Prospectus/KIID must be in German.
 BEL	Dutch, French, German	NO	'Two circulars detailing the simplified notification procedures have been published1) For EU domiciled UCITS wishing to distribute their shares in Belgium (Circulaire FSMA_2011_03 dated 1 July 2011) 2) For Belgian domiciled UCITS wishing to distribute their units in another EU Member State (Circulaire FSMA_2011_04 dated 1 July 2011)'	Dutch, French, German	NO	The full prospectus and financial reports may be submitted in English. The addendum for Belgian shareholders (annexe belge) and copy of the representative and paying agent agreement no longer form part of the notification file.
 BGR	Bulgarian	YES	New law on collective investment schemes has been adopted but not yet officially published. No guidance has yet been issued.	Bulgarian		All documents can be submitted in English to the Financial Supervision Commission except the simplified prospectus/KIID which must be in Bulgarian. The same linguistic requirements apply to documents addressed to Bulgarian investors.
 CYP	Greek, Turkish	NO	Circular n°746 on the marketing arrangements relating to UCITS IV was published on 28 June 2011. The law implementing UCITS IV has not yet been adopted; adoption is expected by the end of August 2011.	English, Greek	YES	All documents of the UCITS shall be submitted to the CySEC in either English or Greek.
 CZE	Czech	YES	No by-laws or methodological instructions have yet been published but these are expected during the month of August.	Czech or another language approved by the Czech regulator	NO	The KIID/simplified prospectus must be translated into Czech or other language approved by the regulator. The UCITS certificate and the notification letter are accepted in English. The full prospectus and financial reports may be submitted in Czech, the other approved language (Slovak) or in English. Nevertheless, the documents addressed directly to investors such as marketing information or notices must still be translated in Czech.
 DNK	Danish	YES	On 28 June 2011 the Executive Order n°746 on marketing carried out by foreign investment undertakings in Denmark, implementing the simplified notification procedure of the UCITS IV Directive was adopted, effective 1 July 2011. The Danish Investment Associations Act was adopted by Parliament on 18 May 2011.	Danish (state authorised translation)	YES	All documents of the UCITS excluding the simplified prospectus/KIID will be accepted in English, Norwegian or Swedish. The Danish FSA also requires the following information to be submitted as supplement to the full prospectus - details of the Danish representative, taxation regulations, information required to be provided to investors in the country of domicile and measures to redeem shares and receive dividends. This information can also be included in the full prospectus. The notification package must also include an Excel file listing all the sub-funds/share classes/ISIN codes.

* Deloitte shall not be held responsible or liable for any loss, damage, expenses or other consequences (together 'Losses') incurred as a result of information contained in this UCITS IV update (hereafter 'Information') being misinterpreted by the reader or any other party having taken knowledge of the information.

The information contained in this table was reviewed by Deloitte Regulatory Consulting on a best endeavours basis and represents the results of our findings as per 22 August 2011. As UCITS IV implementation is on-going, this information is subject to change at any time.








Parallel filing/ infos after 1 July	Maintenance process	Marketing documents	Comments
	<p>The following email address is to be used for receipt of maintenance files - funds@fma.gv.at</p>		<p>The text of the new law on undertakings for collective investments will be included in the Investmentfondsgesetz 2011 (InvFG) which will enter into force on 1 September 2011. The resolution adopting the new law (1254 der Beilagen XXIV.GP) can be found on the Parliament's website. The FMA's new guidelines for UCITS IV Notification 'Merkblatt 2011' is available on their website.</p>
<p>The FSMA does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.</p>	<p>'Maintenance files will continue to be sent to the FSMA as before. Maintenance includes but is not limited to changes to the prospectus/KIID, launch of new share classes in already registered sub-funds and name changes. Registration of new sub-funds will be done via the home member state regulator. If there are any changes to the share classes to be marketed in Belgium or the method that shares are marketed in Belgium, then the UCITS must inform the FSMA directly.'</p>		<p>'The circular for EU domiciled UCITS provides details on the:</p> <ul style="list-style-type: none"> • New simplified notification procedure • Information which should be made available to the FSMA and Belgian investors • Procedure to stop the marketing of shares in Belgium'
			<p>Under the new proposal, foreign domiciled UCITS are still required to enter into an agreement with a Bulgarian bank or a branch of a foreign bank to facilitate investor transaction requests.</p>
<p>The CySEC does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.</p>			<p>'Under the new rules, UCITS domiciled in another member state will be required to appoint a credit institution established in the Republic of Cyprus as a paying agent to facilitate payments to the shareholders/unitholders, and the redemption and repurchase of shares/units. The requirement to appoint a local paying agent will become obligatory upon the transposition of the EU Directive 2009/65/EC into Cypriot national law. In the case that documents of the UCITS are made available to investors only in English, the UCITS is required to confirm to the CySEC in writing that they will only market their units/shares to investors who have declared in writing that they understand English.'</p>
<p>The CNB does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.</p>	<p>The following email address is to be used for receipt of maintenance files - podatelna@cnb.cz</p>		<p>'UCITS will still need to enter into an agreement with a Czech bank or branch of a foreign bank, to facilitate yield payments, investor transaction requests and to publish the required information. For maintenance according to Article 93(8) of the Directive, no formal procedure is required, an informative email with link to the updated documents is sufficient.'</p>
<p>The Danish FSA does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.</p>	<p>For maintenance and prospectus updates, it will be sufficient to inform the Danish FSA via the dedicated email address and indicate where the updated documents are available in electronic format. Changes to the marketing plan or the name and address of the UCITS must be notified to the Danish FSA no later than 14 days after the decision to make the change has been taken.</p>	<p>Marketing documents must be in accordance with the Executive Order on good business practice for financial undertakings in Denmark and must comply with other legislation including the Danish Marketing Practices Act.</p>	<p>'The new Executive Order contains the following main provisions:</p> <ul style="list-style-type: none"> • Notification procedure and required information to be provided to the Danish investors by the foreign UCITS • Application procedure for approval of marketing of non-UCITS • Distinction between marketing solely to professional investors and marketing to retail investors in which case it is required to appoint a local representative in Denmark • Introduction of annual and registration fees charged by the Danish FSA; invoices will be issued at the beginning of December and are to be paid by the end of the year'

UCITS IV implementation status

Country	Official languages	Transposed into local law	Advancement status	KIID language	Certified translations	Notification procedure
 EST	Estonian	NO	On 1 July 2011, the Estonian Financial Supervision Commission published new instructions for the marketing of UCITS of other EU member states in Estonia. Transposition of the UCITS IV law is expected shortly.	Estonian	NO	All documents of the UCITS shall be submitted to the Financial Supervision Commission in either English or Estonian. Only the simplified prospectus/KIID must be in Estonian.
 FIN	Finnish, Swedish	NO	'The Finnish Financial Supervisory Authority published its new simplified notification procedure for EU domiciled UCITS wishing to distribute their shares in Finland. Implementation of UCITS IV is expected in the autumn and draft regulations are available in Finnish and Swedish.'	Finnish, Swedish	NO	All documents of the UCITS must be made available in English, Finnish or Swedish. Simplified prospectuses, which may be in Finnish or Swedish, will be accepted until 1 July 2012. The document 'Important Information for Finnish Investors' is no longer required after 1 July 2011, but the information contained therein must be included in the notification letter.
 FRA	French	NO	Signed off by the French government but not yet published in the Official Journal.	French	NO	The required documents are listed in Article 93 of the UCITS IV Directive and those listed in the appendix of the AMF Regulation n° 584/2010.
 DEU	German	YES	The UCITS IV Act - OGAW-IV-Umsetzungsgesetz has been enacted.	German	NO	All documents of the UCITS shall be submitted to the BaFIN in either English or German. Only the simplified prospectus/KIID must be in German.
 GRC	Greek	NO	The HCMC is working on the transposition.	Greek	NO	
 HUN	Hungarian	NO	Transposition is expected by the end of 2011.			
 IRL	Irish, English	YES	The CBI has published guidelines and UCITS Notices, all of which are available on their website.	English, Irish	NO	Information on the appointment of a facilities agent must be included in the full prospectus.
 ITA	Italian	NO	'Approval of the Law implementing UCITS IV does not form part of the Government's Agenda before August 2011. On 5 July 2011, the CONSOB issued a Communication regarding the simplified notification process for EU domiciled UCITS wishing to distribute their units in Italy.'	Italian	NO	'The full prospectus shall be translated into Italian or into a language customary in the sphere of international finance. Once the notification package has been submitted, a second and final deposit of the full prospectus (which can be in English), the simplified prospectus/KIID (in Italian) and the revised Italian subscription form must be done once the CONSOB has granted its authorisation.'
 LVA	Latvian	NO	Transposition is expected by the end of 2011.			
 LTU	Lithuanian	NO	Transposition is expected by the end of 2011.	Lithuanian	NO	All documents of the UCITS shall be submitted in either English or Lithuanian. Only the simplified prospectus/KIID must be in Lithuanian.






Parallel filing/ infos after 1 July	Maintenance process	Marketing documents	Comments
			Foreign domiciled UCITS may start offering their shares upon submission of a notification letter containing information on the marketing arrangements in Estonia.
The FIN-FSA does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.	The following email address is to be used for receipt of maintenance files - funds@finanssivalvonta.fi		The FIN-FSA has published draft UCITS IV guidelines on its website.
The AMF does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator	The following email address is to be used for receipt of maintenance files - gio@amf-france.org	Until further notice, marketing documents should be sent to the AMF for review.	A KIID will also need to be prepared for non-UCITS registered for distribution in France.
	The following email address is to be used for receipt of maintenance files - UCITS-Update@bafin.de		<p>The BaFIN has published its new Guidelines for UCITS notifications dated 30 June 2011 (Merkblatt 2011). The most important changes addressed by this Merkblatt (2011) include the following:</p> <ul style="list-style-type: none"> • Publication requirements • Language of documents to be used • Grandfathering period for foreign funds, which still use the simplified prospectus • Distribution requirements'
			Although UCITS IV has not yet been transposed, the HCMC advises UCITS to follow the Directive when submitting notifications e.g. notification to the HCMC via the home state regulator and KIID to be translated into Greek.
The CBI does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.	The following email address is to be used for receipt of maintenance files - UCITSinwardmarketing@centralbank.ie	The UCITS must comply with the advertising standards issued by the CBI.	The foreign domiciled UCITS must still appoint a facilities agent based in Ireland who in turn must provide a written confirmation to the CBI that they have agreed to act as such for the UCITS.
			The 'Nota Informativa' may no longer be required but this is still to be confirmed
			Financial and Capital Market Commission has informed that 'ucitsnotification@fktk.lv' is the designated e-mail address for notifications.

UCITS IV implementation status

Country	Official languages	Transposed into local law	Advancement status	KIID language	Certified translations	Notification procedure
 LUX	French, German, Luxembourgish	YES	UCITS IV transposed into national law on 17 December 2010.	French, German, Luxembourgish, English	NO	'UCITS must comply with the requirements of CSSF Circular 11/509 on the simplified notification process. For Luxembourg domiciled UCITS wishing to market their units in another member state of the EU: - The latest electronic version of the Management Regulations/Articles of Incorporation, as submitted to the CSSF according to the principles of the CSSF Circular 08/371, must be included - As appropriate the management company identifier and email address must be made available - The units/share class identifiers must be confirmed, if not already included in the specific Excel spreadsheet published on the CSSF website For UCITS of another member state of the EU wishing to market their units in Luxembourg - the UCITS must ensure that the CSSF receives: - The documentation referred to in paragraphs (1) and (2) of Article 93 of the UCITS Directive - An attestation that the UCITS fulfils the conditions imposed by the UCITS Directive from the competent authorities of the home member state'
 MLT	Maltese, English	YES	The Malta Financial Services Authority (MFSA) has transposed the UCITS IV Directive by means of regulations. Three legal notices regarding marketing of UCITS, UCITS mergers and UCITS management company passport, with effective date of 1 July 2011, have been published.	English, Maltese	NO	All documents may be submitted in English or Maltese at the choice of UCITS. As part of the notification file the foreign UCITS shall provide the MFSA with information on the facilities for making payments and making the required information available to investors in Malta - this requirement can be satisfied by appointing a facilities agent in Malta.
 NLD	Dutch	YES	On 5 July 2011, the Dutch Senate formally accepted, with effect on 1 July 2011 the proposed changes to the Financial Supervision Act, the Civil Code and the implementation guidelines to adopt UCITS IV legislation into national law.	Dutch or any other language approved by the AFM in the future	NO	'The full prospectus and financial reports may be submitted in English. For all UCITS and non-UCITS registered for distribution in the Netherlands, the GUISE Risk Indicator warning will eventually be replaced by the Synthetic Risk and Reward Indicator (SRRI) in all marketing material, once the SRRI has been calculated.'
 POL	Polish	NO	The KNF has issued guidance describing the interim procedure prior to transposition which is expected by the end of 2011.	Polish	NO	
 PRT	Portuguese	NO	The CMVM is working on the transposition.	Portuguese	NO	
 ROM	Romanian	NO	Transposition is expected by the end of 2011.	Romanian		
 SVK	Slovak	YES	The National Bank of Slovakia (NBS) has issued its Methodological Instructions on the UCITS IV regulation.	Slovak	NO	'All documents must be submitted in original language; if this is not English, then these documents must be translated into either Slovak or English. In accordance with the UCITS IV Directive and EU Regulation no 584/2010, the NBS accepts the standard notification package for the initial registration of the UCITS and for new or additional sub-funds.'

Parallel filing/ infos after 1 July	Maintenance process	Marketing documents	Comments
The CSSF does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.	Maintenance files will be sent directly to the CSSF.		'Only new UCITS IV attestation letters, issued by the CSSF after 1 July 2011, should be included in the UCITS IV notification package. When completing notification letters, all fields must be filled, i.e. no blanks should be left or fields be deleted (and 'not applicable' or similar wording should be inserted, if necessary).'
The MFSA does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.		The MFSA has a right to verify that marketing information of foreign UCITS issued in Malta are compliant with the respective legislation in Malta.	All required documents may be sent to the MFSA via the dedicated email address.
The AFM wishes to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator. The following email address is to be used - ucits@afm.nl	The following email address is to be used for receipt of maintenance files - ucits@afm.nl	'Promoters must update their current factsheets and calculate the GUISE indicators before 1 July 2012. English is accepted for the factsheets.'	Since the national law implementing the Directive has not yet been adopted, the direct effect of its relevant provisions is envisaged. The EU Commission Regulation 584/2010 is directly applicable per se. Although UCITS IV has not yet been transposed, the CMVM advises UCITS to follow the Directive when submitting notifications e.g. notification to the CMVM via the home state regulator and KIID to be translated into Portuguese.
	The NBS requires the email for maintenance files to be named according to its specific subject naming convention.		The NBS no longer needs to receive the additional information for Slovak investors, any specific marketing documents or copies of the financial reports.

UCITS IV implementation status

Country	Official languages	Transposed into local law	Advancement status	KIID language	Certified translations	Notification procedure
ESP 	Spanish	NO	'On 22 June 2011, the CNMV Circular 2/2011 implementing UCITS IV was published in the Boletín Oficial del Estado, which became effective on 1 July 2011. Regarding transposition into national law, draft legislation has been issued and is in parliamentary process.'	Spanish	NO	Only the simplified prospectus/KIID must be translated into Spanish, all other documents can be submitted in English.
SWE 	Swedish	NO	UCITS IV will come into force on 1 August 2011.	Swedish	NO	KIID/simplified prospectus will be accepted in both English and Swedish until 1 July 2012. All other documents can be submitted in either Norwegian, Danish or English. The document 'Important Information for Swedish Investors' is no longer required after 1 July 2011.
GBR 	English	YES	The FSA has updated its Handbook COLL (Collective Investment Schemes) and the COLLG (The Collective Investment Scheme Information Guide.)	English	NO	For prospectus updates, the FSA requires the updated form 264CH to be sent directly by the UCITS to the FSA by email.
ISL 	Icelandic	N/A				
LIE 	German	N/A	It is foreseen that the law will be published and applicable as of 1 August 2011.	German	NO	
NOR 	Norwegian, Sámi	N/A	The proposed text of the new legislation will be forwarded to Parliament in September 2011.	Norwegian	NO	After 1 July 2012, only the KIID will be accepted, until then the simplified prospectus may be used
CHE 	German, French, Italian	N/A	The transposition of the KIID entered into force on 15 July 2011 by means of an amendment to the Swiss Federal Ordinance of 22 November 2006 on Collective Investment Schemes (CISO).	German, French, Italian	NO	

Parallel filing/ infos after 1 July	Maintenance process	Marketing documents	Comments
	<p>'The following email address is to be used for receipt of maintenance files - ucits.updates@cnmv.es. CIFRADOCC is no longer used and the 'appointed entity' will be in charge of this submission.'</p>	<p>A new Marketing Memorandum (Memoria de Comercialización) has been issued by the CNMV.</p>	<p>'Among others, the new Circular establishes: - A new notification procedure enabling direct communication between the foreign fund and the CNMV - A list of documents to be made available to the CNMV and to the local investors'</p>
<p>The Finansinspektionen does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.</p>	<p>The following email address is to be used for receipt of maintenance files - finansinspektionen@fi.se</p>		<p>'Starting 1 August 2011 there will no longer be any fees for notification of UCITS from other EU member states in Sweden or for the registration of new sub-funds. Guidelines will be published in English before 1 August 2011.'</p>
<p>The FSA does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.</p>	<p>The following email address is to be used for receipt of maintenance files - recognisedcis@fsa.gov.uk</p>		<p>The requirement to appoint a facilities agent is maintained as are the annual and periodic registration fees.</p>
<p>The Finanstilsynet does not wish to receive a duplicate copy of the notification package sent by the UCITS to the home member state regulator.</p>	<p>The following email address is to be used for receipt of maintenance files - post@finansstilsynet.no</p>		<p>'The addendum for Norwegian investors can now be submitted in English and that it will be sufficient that the financial reports are made available to shareholders on the UCITS' website. In the case of funds aimed exclusively at professional investors, it will also be possible to grant dispensation, on a case-by-case basis, to deliver the KIID in English.'</p>
			<p>'The new article 107a and the new Annex 3 refer to the legal base for the KIID and confirm that it will be required for foreign UCITS and Non-UCITS. Whereas the contents of the KIID will be as set out under the UCITS IV Directive, its denomination will not change and will remain the 'simplified prospectus' under the CISA.</p> <p>The grandfathering period for the use of the KIID can be summarised as follows:</p> <ul style="list-style-type: none"> • For existing funds (Swiss securities funds, other funds for traditional investments, UCITS and Non-UCITS except real estate funds), KIID must be used within three years following CISO amendment (15 July 2014 at the latest) • For new funds (Swiss securities funds, other Swiss funds for traditional investments, UCITS and Non-UCITS except real estate funds), fund promoters may use the actual simplified prospectus until 14 July 2012 - i.e from 15 July 2012, all Swiss and foreign funds (UCITS and Non-UCITS) must publish a KIID <p>On 15 July 2011, the FINMA published additional information:</p> <ul style="list-style-type: none"> • KIID will no longer need to be signed by the three counterparties (UCITS, Custodian and Swiss Representative) as is currently the case for simplified prospectus • A predefined checklist must be completed for each prospectus update and submission of the financial reports • For each request for authorisation of distribution and/or prospectus update, a 'declaration' must be submitted detailing the use of master-feeder structures within the UCITS, the status of the management company passport and if the UCITS is to be marketed as an ETF • The compulsory Swiss disclaimer must be included in the body of the KIID and will be much shorter than the current version'

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