

Performance

A triannual topical digest for investment management professionals, issue 15, September 2014



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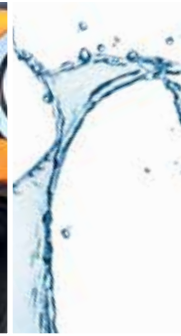
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Foreword



Dear readers and friends,

Each year, September comes around as something of a turning point. It marks the end of the 'summer doldrums' in years when activity does slack off during the summer months. More importantly, it marks the beginning of the rush toward year end as outstanding projects become more and more urgent—budget and market permitting. To us, September means the latest edition of *Performance*, as varied, rich, informative and enlightening as ever, and with a 'spice' of topicality specially put together for the projects and subjects which define the final quarter of the year.

We are particularly pleased to see such strong support from our contributors outside of Deloitte. In this edition, possibly for the first time, articles written by external contributors outnumber our own input. We consider this fact as a real coming of age for this forum of expertise. It was always our intention that this journal should be 'your' publication, where you talk about issues important to 'you'. With this edition, we feel that we are getting closer to that goal. It would be invidious to single out individual contributors among such distinguished authorities, all recognised as leading lights in their respective fields. We should, however, like to thank them for their insights, their kind cooperation, and for taking the time to share their views with us all.

The articles in this issue read like a roll call of the key developments and preoccupations in our market. It is not without reason that MiFID II, with its bewildering array of different chapters, attracts not one, but two articles with different perspectives on different parts of a unique 'bundle' of complex texts and reforms. Still more ink will flow before we come to the end of the assimilation and implementation process of that particular Directive. You may also read about the latest developments in the field of market infrastructure, the ineluctable march from B2B bespoke arrangements to centralisation and standardisation in the context of T2S, the CSD Regulation and in a separate contribution how CSD's are entering the hedge fund trading and infrastructure space. There are inevitably further reflections on governance, and alongside those, thoughts on inter alia prime broker models. You will also find in depth insights into the CSSF Depository Circular, hot off the press and perhaps piloting the way forward in terms of market best practice in the wake of the rich, and at times heated, debates on depository issues that have accompanied both AIFMD and UCITS V. Inevitably we must speak of tax, and what transparency means for the local industry, but we are delighted to offer as a counterpoint the more exotic, if complementary, environment to be found in Mauritius with its very specific asset servicing possibilities.

We would venture to suggest that in this edition there is indeed something for everybody. Before you plunge into this 'final straight' of 2014, please take in the shared experiences of our esteemed contributors and enjoy what is more and more your magazine.

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Editorial

Dear readers,

"*May you live in interesting times*" is said to be the English translation of a Chinese curse. Curse or not, these are certainly interesting times for the Investment Management sector. Some of our markets, such as the U.S., UK and China, are returning to strong growth whilst the eurozone and many emerging markets remain under pressure. Macro intervention may be contributing to asset bubbles driving a hunt for yield, whilst pressure on operating models, returns and pricing is leading to restructuring across the sector. Nevertheless, AUM has continued to see strong growth over the last few years and most market participants expect this growth to continue over the medium term.

This, the 15th edition of *Performance*, addresses some of the interesting challenges facing asset managers. To set the scene, we take a look at how Martin Gilbert, the CEO of Aberdeen Asset Management, grew Aberdeen into what is now Europe's largest listed fund manager. We later explore the changing investment management landscape in markets such as the UK and Mauritius and sub-sector groups such as securities lending and hedge funds.

If 'interesting' is a curse, it is that simply doing what we have always done is no longer good enough. The sector is growing and the outlook is overwhelmingly positive, but competition is also growing and regulators continue to increase the requirements on asset managers. Our view is that we are indeed seeing a seismic shift in the sector and that those market participants who embrace the opportunity to change will emerge on top whilst others will, perhaps, fall by the wayside. It will take innovation and agility to succeed, as well as a laser-like focus on effective execution. We believe the curse is in fact an opportunity and a clear call to action where the 'winner takes all'.

We hope you enjoy this latest edition of *Performance*.



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Martin Gilbert

Martin Gilbert is the Chief Executive and a co-founder of Aberdeen Asset Management PLC, the holding company of the fund management group that was established in 1983. Under Martin's leadership, Aberdeen has become Europe's largest listed fund manager through a combination of organic growth and acquisition. Martin is also Adjunct Professor of Finance at Imperial College Business School and a member of the Scottish Government's Financial Services Advisory Board, the EFAMA President's Advisory Council and the Institute of Chartered Accountants of Scotland.

Martin divides his time between Aberdeen, where the business has always been headquartered, and London, as well as overseeing the international operations of the Group.

“Alpha male

Deloitte partners David Barnes and Margaret Doyle meet Martin Gilbert, co-founder and Chief Executive Officer (CEO) of Aberdeen Asset Management, at his London office to ask him about his success to date and plans for Europe's largest listed fund manager.

Martin Gilbert is restless. He has just catapulted Aberdeen to the top of Europe's fund management league by acquiring Scottish Widows Investment Partnership (SWIP) from Lloyds Banking Group. This has tilted the group away from its traditional Asian heartland. Now he wants to pivot further west, by expanding in the U.S.

Aberdeen's is a story of a near-miraculous turnaround—barely a decade ago, its future hung in the balance when it got caught up in the UK's 'split-caps' affair.

Interviewed by David Barnes and Margaret Doyle, Deloitte LLP

Capital punishment

Various investment trusts that were backed by Aberdeen and designed to preserve investors' capital, took on too much debt and collapsed. Its own share price plummeted by more than 90%. A £200 million debt burden dwarfed its shrunken £46 million market cap. That has since rebounded and now stands at £6 billion¹ (see figure 1).

Painful as the split-caps affair was for Gilbert, it changed his attitude to debt. He explains, "After 2002 to 2004, we said we were never going to have debt again." It also made him sceptical about more exotic securities in the run-up to the financial crisis. "We weren't in CDOs [collateralised debt obligations-complex bundles of securitised bonds]," Gilbert explains. "We knew they were toxic... I knew that they were all going to collapse".

Team approach

One thing that undoubtedly helped sustain the company was a tight team that had spent more than a decade together before the split-caps affair hit. It is still led by a remarkable quintet of individuals who have worked together for a quarter of a century. Gilbert believes this is a key strategic asset.

Figure 1: Share price (since 2002, GBP)



"Five guys who have done 25 years, and four of them on the board," he marvels. He adds, "If you look at [our] board, it's by far and away the most skewed of FTSE 100 companies in terms of longevity of the executives. No other company has that stability."

The group's heritage is largely in equity investment, where a bottom-up, stock-picking approach is well-embedded (of which more below). "In other areas, where we look to grow, we've had to work hard on merging the businesses and really taking ... best of breed," Gilbert says, adding, "We haven't quite got to...the 'equity culture' in some of our other businesses, but the target is to get to that with these other businesses."

Deal-making

Post-merger integration is another of the group's strategic strengths. "They [vendors] want to know you can execute the deal," he says, adding, "Lots of people can pay."

In other areas, where we look to grow, we've had to work hard on merging the businesses and really taking ... best of breed

Martin Gilbert

¹ Share price as of 23 July 2014, retrieved from Bloomberg

Every deal since it bought the investment management arm of Aitken Hume, a boutique investment bank, in 1988 has given subsequent vendors more confidence in its ability to manage post-merger integration.

Gilbert believes this was a key reason why the group saw off the competition for SWIP: *“As soon as we entered the fray, the others knew they’d lost because they couldn’t integrate.”*

Women’s work

If Gilbert’s chief legacy is to have built a global investment powerhouse from a Scottish boutique, he is now turning to the broader challenge of women in business. Gilbert proudly tells Deloitte of the work that Anne Richards, Chief Investment Officer, is doing to increase the number of women in STEM – Science, Technology, Engineering and Mathematics.

While some in the corporate world, such as the 30% club, aim to increase the number of female board directors, Gilbert’s assessment of the problem is different. He says, *“The issue is not at the main board level, it’s at management level.”*

He believes the accounting profession, of which he is a member, could offer a solution. A qualified accountant himself, Gilbert says *“It’s actually not a bad job. You can take a career break.”* He is surprised when told that women appear to be choosing the law over accountancy, (he studied both), remarking bluntly, *“I don’t understand why anyone would want to be a lawyer.”*

Given that the route to CEO is increasingly via the Chief Financial Officer (CFO) role—Gilbert reckons that as many as half of new CEOs are former CFOs—he warns, *“Until we get more women into CFO roles, we won’t get them into CEO roles.”*

Gilbert is putting his money where his mouth is. In 2013, he stipulated that the Scottish Open would not be held at any men-only club during Aberdeen’s four-year sponsorship of the golf tournament.²

Bottom-up

The group’s stock-picking approach determines its investment choices and outcomes. *“This bottom-up view... moves us away from China to India.... Governance, quality of management, all come into effect,”* he says.

Another consequence was that there were no developed market banks in their global equity portfolios when the financial crisis hit. The group got out as early as 2006, when its fund managers *“asked, ‘Which bank would you invest in? One that lends only three times an applicant’s salary and undertakes rigorous credit checks. The other offers mortgages at five times salary, doesn’t review the applicant’s outgoings and doesn’t require a deposit,’”* Gilbert recalls, adding, *“You just thought, ‘it’s all going to fall apart.’”*

The group does not hedge against macroeconomic risks, like currency movements. Gilbert says most rival fund managers are *“obsessed”* with politics and economics. He quotes Hugh Young, his star Asian fund manager, saying his peers *“would much rather spend 90% of their time discussing politics and macroeconomics and 10% looking at companies. We try and do the opposite.”*

The conventional wisdom may be that asset values are dominated by policy choices, like quantitative easing, but Gilbert believes that policy *“doesn’t have a dramatic effect on a lot of companies we invest in.”*

Of course, the effect of not hedging is that many of its funds tend to be quite volatile. Gilbert admits that, *“We got hammered from November to February,”* as weakness in emerging market currencies and stocks prompted outflows from its funds.

The lesson reinforced by last year’s sell-off—of its own shares as well as of their underlying funds—was, Gilbert says, that *“we were [too] reliant on three products. We are [now] trying to diversify.”* This diversification will be by both geography and asset class.

We were [too] reliant on three products.
We are [now] trying to diversify

Martin Gilbert

² ‘Scottish Open will not go to men-only clubs’, *The Scotsman*, 30 July 2013. See also: <http://www.scotsman.com/news/politics/top-stories/scottish-open-will-not-go-to-men-only-clubs-1-3020635>

Westward ho!

Gilbert acknowledges that, “our industry is dominated by Americans.” While the group is Europe’s largest listed fund manager, (see figure 2 for the growth in assets under management), it is only the sixth largest listed fund manager in the world, with the top five being American.³ “Half the world’s wealth is still there,” Gilbert explains.

Gilbert knows that cracking America will be tough. Much of the group’s success to date has been through Gilbert’s ability to spot—and do—deals.

But Gilbert recognises that in “America [it] is difficult to do deals.” He adds, “Most of the deals in America involve buying from owners. Buying from owners is difficult. We only buy from corporates.” So the growth strategy in the U.S. will be “more organic than anything else”.

Alpha and beta

Alongside U.S. expansion, Gilbert plans to build quant funds: “That’s where we want to be, rather than absolute index tracking.” Quantitative investment strategies rely on mathematical models to generate above-market return, or ‘alpha’.

This is the opposite of passive investing, which aims to capture market movements, or ‘beta’.

Unlike some active managers, who pooh-pooh passive investing as unthinking, Gilbert respects the competition, observing that “the skill set required is massive”. Gilbert also recognises that tight passive management margins demand scale.

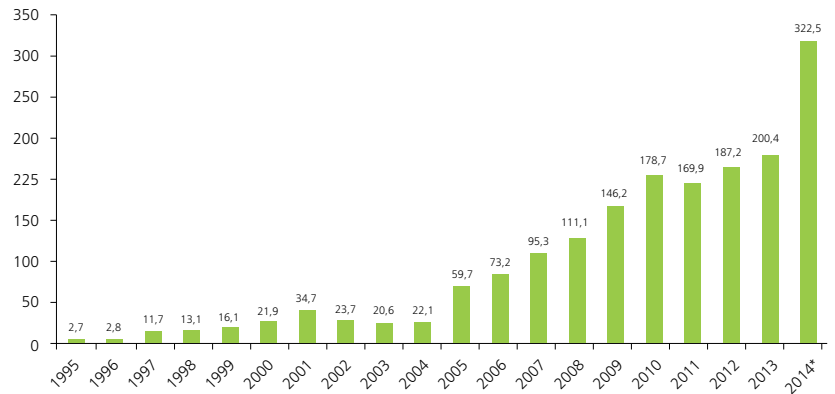
Pension pot luck

Gilbert believes that ‘quant’ will provide a vehicle for pension savings, or ‘accumulation’, but he is cautious on cooking up new ‘decumulation’ products for British pensioners. Those with their own defined-contribution pension pot will no longer be pushed into buying an annuity following a UK policy change.

Gilbert is sceptical about whether this will be the boon for asset managers that many (including Deloitte) expect. He warns, “You should never underestimate the ability of insurers. They own the clients.” He adds, “Don’t underestimate their ability to influence legislation. They are a powerful lobby.”

Figure 2: Aberdeen’s assets under management have increased more than one-hundred fold (including SWIP) over the past two decades*

Asset under management (£bn)



* AUM as on June 30, 2014, from their interim management statement

Gilbert believes that ‘quant’ will provide a vehicle for pension savings, or ‘accumulation’

I will survive

Gilbert has himself been part of Britain’s political process. He was grilled by the Treasury Committee over split-caps in 2002. He was taken off-guard by the experience, a modern equivalent of medieval stocks, where high-profile witnesses are subject to ritual humiliation.

Now, he is mates with Lord (John) McFall, then the Committee’s chairman. But then Gilbert was blindsided when his fellow Scot told him that investors say “you are sophisticated snake-oil salesmen.”

It was two-and-a-half years in all before the Group was on an even keel again. These days, many in the line of fire would have a coach to help cope with the stress. Gilbert’s approach was rather more old-school. “You’ve got to survive,” he reflects, “That’s the lesson. Survival is the key. Just survive.”



³ Aberdeen was the joint-sixth largest listed fund manager in the world, alongside Affiliated Managers Group, after Blackrock, Franklin Resources, Invesco, T Rowe Price and Legg Mason, according to Credit Suisse’s weekly review, dated July 11, 2014, and using the dollar/sterling exchange rate on that date from Oanda. Vanguard managed US\$2.9 trillion as of March 31, 2014, and Fidelity US\$1.9 trillion as of April 30, 2014, but neither is listed



Hot topic
question

Innovation

The street is also a real-world laboratory for the financial sector

Navi Radjou

Co-author of the global bestseller
'Jugaad Innovation: Think Frugal, Be
Flexible, Generate Breakthrough Growth.'



Navi Radjou

Navi Radjou is a French citizen born in the former French territory of Pondicherry in India. Based now in Palo Alto, Silicon Valley, he is a strategy advisor on innovation and leadership, a best-selling book author, and a Fellow at Cambridge University's Judge Business School. In the past, Navi has also occupied eminent positions such as vice-president at Forrester Research in Boston and San Francisco and as member of the World Economic Forum. Navi is a graduate of Ecole Centrale Paris.

Navi's expertise covers business innovation, but he has devoted himself more specifically to frugal innovation—or Jugaad—that is practised by resourceful entrepreneurs in developing countries and has explored this field in his best-selling book 'Jugaad Innovation'.

Today, Navi Radjou's reputation has spread worldwide, through the many awards he has received (including the 2013 Thinkers50 Innovation Award), his participation in high-profile events and his interviews in top-tier newspapers.



Deloitte: How can the concept of 'jugaad' impact the world of finance?

Navi Radjou

Jugaad is practised today by millions of entrepreneurs in emerging markets such as India, Africa and Brazil that face huge complexity and severe resource constraints. These constraints, whether due to a lack of resources, complex regulations or insufficient infrastructure, create an atmosphere of adversity. Adversity is the mother of invention.

In this difficult environment, people are pushed to innovate just to survive. But they tend to innovate differently. Rather than relying on large research and development laboratories as we do in the West, people in India and Africa are using their innate ingenuity to create a pragmatic solution, a practice generally referred to as 'Système D' in France or 'jugaad' in India. Jugaad entrepreneurs live in close contact with their potential customers, directly in the streets. The street is a real-world laboratory where entrepreneurs identify needs and try to find solutions.

In India, the 'jugaad vehicles' often found in the countryside are makeshift vehicles assembled out of a carriage and an agricultural water pump reconditioned as an engine, for less than €1,000. They are very simple and do not exceed 60 km/h, but have the capacity to transport up to 20 people from villages to cities and operate in all weather conditions and terrain. As such, they meet very well the needs of the local rural population and at a very low cost.

Jugaad is therefore a frugal approach to innovation requiring few resources, as well as being agile in that the jugaad innovator needs to constantly adapt to rapidly evolving customer needs. It is also an inclusive approach for two reasons: first because it includes the final consumer in the co-creation of value and, second, it also includes economically marginalised segments of the population while generating reasonable profits, demonstrating that jugaad is a profitable business model.

The street is a real-world laboratory where entrepreneurs identify needs and try to find solutions

Inspired by the frugal, flexible and inclusive mindset of jugaad innovators, some large corporations such as Orange have now provided innovative solutions that financial institutions would be inspired to follow. For example, Orange money or 'M-pesa' (introduced by Vodafone in Kenya) allows people to send and receive money as well as lend or donate money to friends and families, pay bills and provide access to dedicated services. This has revolutionised the lives of millions of people in Africa. Africa is going to teach us in the West how to offer financial solutions that are affordable and inclusive.

Deloitte: Should financial institutions feel concerned by these populations?

Navi Radjou

Absolutely! Because financial exclusion is not limited to poorer countries. For example, in the United States, over 70 million Americans or one quarter of the population are underserved by the traditional financial institutions, while for the year 2012 alone, these same Americans spent nearly US\$90 billion in interest and fees! This means that the concept of financial exclusion, which is often associated with developing countries, is becoming a critical issue in industrialised countries too. However, if you are a banking institution and if you apply the jugaad mindset, this financial exclusion issue can also create an opportunity for you.

For instance, American Express has partnered with Walmart to offer prepaid cards. Additionally, tech vendors and start-ups such as PayNearMe, Square and Google Wallet now offer alternative payment solutions either online or by mobile phone and enable people to make e-commerce transactions using cash instead of a credit card.

American Express recently created a 'Financial Innovation Lab' to experiment with new offerings aimed at underserved markets that differ from the traditional products of the bank. This lab will co-create its frugal solutions with end-users. American Express has also set up a venture fund to invest in promising start-ups focused on financial inclusion. I believe many companies will follow this example in the coming years.

Flexible pricing models such as 'Pay as you go' should logically increase in the insurance sector. Take, for instance, the particular example of Progressive, the auto insurer in the U.S. which offers a device, called Snapshot, that is already installed in the vehicles of over 1 million clients to capture their driving habits and dynamically adjust their 'premium' accordingly. There are now about 20 million connected vehicles in the world, and this number should reach 600 million by 2025 and thus the penetration of telematics and pay-as-you-drive car insurance will grow exponentially.

Deloitte: How can companies play a part in this natural evolution?

Navi Radjou

The key challenge is to convince companies to change the way they innovate.

Rather than 'pushing' products to customers, companies must learn to 'pull' needs from customers—by putting themselves in the shoes of consumers. The big danger for large corporations is that they hardly understand that there is a big shift in the consumption values. The Generation Y and Z consumers are individuals who are largely oriented towards digital media and online services and want to engage with brands in a meaningful conversation, not a monologue.

This brings us to a key word: flexibility. Indeed, customers now expect adaptable products and services such as 'Pay as you go' that enable them to get what they want where they want, when they want, at the price they want. I call this trend 'hyper-personalisation'. This new paradigm will challenge companies long used to mass-producing and mass-marketing products.

Deloitte: What are the best practices within companies, in order to stimulate innovation and shift organisations from traditional to innovative?

Navi Radjou

There are several possibilities, as each company has a different culture and needs. I like, for example, the innovation structure created by BNP Paribas called 'l'Atelier', which I find quite unique in the world of finance because it focuses on customers' needs and on the consumption habits of today and tomorrow and technology's impact on them.

A good practice is to create an innovation unit which is separate and, if possible, geographically distant from the headquarters so it is possible to experiment with disruptive new business models and breakthrough products and services. But for this type of structure to be sustainable, three factors are absolutely necessary: first, it must be run by a person of high credibility supported by a member of the executive committee, otherwise there is the danger that the innovation cell is not taken seriously by top management and will be subject to criticism about its activity and cost.

The second factor is that the structure must be open to the outside world through partnerships with start-ups, universities and key players in the world of finance. Lastly, as for the choice of location, European groups can choose Silicon Valley, when American and Asian groups should be looking to Europe, why not choose Luxembourg with its geographical position and its exceptional financial institutions and industry?

Deloitte: Does sociology have a place in the modernisation process of a company?

Navi Radjou

I think it is very important for groups that have been around for 100 years or more to understand the evolution of their corporate culture. When you look at the origins of such businesses, all were founded by entrepreneurs demonstrating a jugaad spirit, because they all had to adapt and improvise.

Over time, however, as these companies mature and leaders change, most lose touch with their entrepreneurial roots and the ways in which they

used to be innovative; for most companies it would be good to reconnect with their inventive roots. I believe a company can maintain a 100-year-old culture and still remain innovative today by leveraging modern Internet and mobile technologies to better serve their customers.

Deloitte: What would be the ideal innovation structure for a foreign company in Luxembourg?

Navi Radjou

I think the best solution for a banking or financial company is to have an innovation hub in Luxembourg with an office in two other creative hotspots, such as the Silicon Valley and a city in a developing country like Shanghai or Bangalore in order to maintain the broadest perspective possible.

Several years ago, when I was at Forrester Research, I co-authored a report that ranks countries based on their ability to build innovation linkages with the rest of the world. In that report, we identified several factors encouraging enterprises to invest in innovative projects in a particular country. In this regard, Luxembourg is a highly appealing business destination for innovation. It is an open and welcoming country with a government attentive to welcoming individuals and businesses, through both its legislative and its fiscal frameworks. It is also easy for a company to establish itself in Luxembourg due to the fast-track process, but also thanks to its well-educated and multilingual workforce and its excellent infrastructure quality. As such, Luxembourg is well positioned to integrate itself into emerging 'global innovation networks'.

Deloitte: Is it possible to respect ROI standards during the early stages of the implementation of an innovation structure?

Navi Radjou

When talking about ROI in the context of innovation, we must first define the right performance indicators. When an innovation structure is created, the indicators are necessarily different. In the early years you have to be flexible because at that stage, this type of structure generates much more intangible value—like new knowledge about customers or emerging technologies—than tangible value.



In the first two years the goals should be: year one, being able to identify key issues and opportunities, and in year 2, initiate prototyping and concepts testing of potential solutions while building the business case for how these solutions will positively impact the organisation. Then, during the third year, they could roll out a business model aimed at scaling up the initial solution.

Finally, for the innovation process to work, you need four right 'ingredients': good strategy, good organisation or structure, good culture, and finally, good leadership. As an example, Allianz has set up in its Munich-based Leadership training centre innovative training programmes entitled 'Dialogue in the Dark' and 'Dialogue in Silence'. These are workshops conducted by blind people in the dark and by deaf people in soundproof environments in order to help participants, who are generally senior leaders, to cultivate empathy and enhance their communication skills.







Global tax and investor reporting

The road ahead

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With ever-growing investor demand for new and innovative offerings, the Asset Management industry is expanding rapidly in both size and complexity. As such, the sector is poised for change across all of its operations. Specifically, the impact on asset managers as they try to manage the tax and regulatory requirements that accompany expansion will be significant.

There are already signs that increasingly complex tax compliance requirements and more extensive investor reporting are being driven by market growth. In turn, this is putting pressure on fund tax teams to evolve and modify the way they work and deliver value to investors and the business.

Highly dependent on third party service providers to perform day-to-day activities and drive change, fund tax teams will almost certainly look to those service providers to guide them through this transformation.



Parallels with the corporate tax world

Understanding the similarities and differences between fund tax and corporate tax is critical to serving the industry, as while there are similarities between the two tax functions, there are also some fundamental differences. Fund tax may have different drivers, needs and ambitions, but as corporate tax has been experiencing a clear operational shift over the past decade, the changes to corporate tax may offer a valuable insight into how fund tax teams can optimise their operating model and respond to market change.

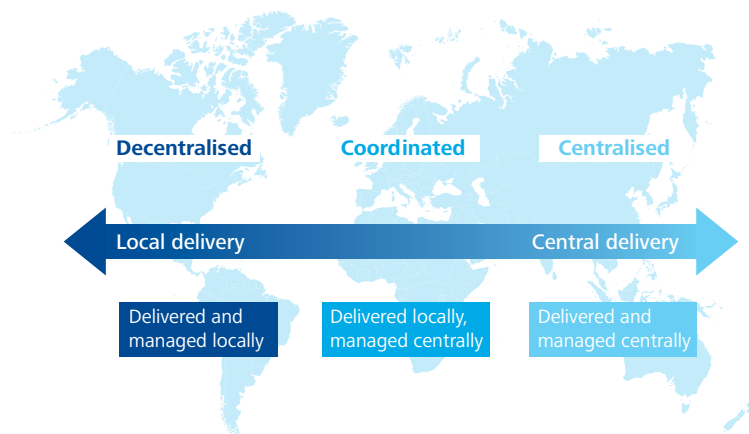
In recent independent market research commissioned by Deloitte to explore fund tax within the Asset Management industry¹, we uncovered common themes across the sector and identified the main practices driving industry leaders to the front of the pack. Although the fund tax operating models observed in our research are difficult to break down into clearly defined categories, it is clear that they all sit on a

spectrum that ranges from a mostly decentralised operating model at one end to a mostly centralised model at the other.

Also evident is a direction of travel suggesting that as fund managers grasp and address the challenges of growth, they generally tend to move along this continuum towards more centralised models and ways of working. This finding is consistent with what we have observed in the corporate tax arena.

The results of a significant global survey of over 250 global tax heads, commissioned by Deloitte in 2010 and repeated in 2012, helped us to understand the wider themes emerging in corporate tax. These included the global market drivers that have pushed many corporate tax teams to move along the continuum described above towards more centralised models, with the objective of achieving greater global control, oversight and visibility.

Spectrum of Operating Models



¹ See 'Global Tax and Investor Reporting: A changing landscape' in Performance Magazine, issue 14 for an in depth look at a deeper dive into survey results

Many corporate tax teams – particularly the more pioneering companies already sitting on the right of the continuum – had been empowered and were expected to create added value for their organisations by consolidating service providers, investing in technology and resources, and driving change and improvement.

Consequently, as the tax and reporting operating models within the asset management sector seem set to follow a similar trajectory to the corporate world, the comparison does provide some insight into the challenges on the horizon for asset managers and their fund tax teams.

Barriers to change

Although there is an appetite and a precedent for change, there are some critical hurdles that fund tax teams will have to clear before a significant shift in operating model can occur. The barriers to change that exist within fund tax are found less frequently in corporate tax and help to highlight the differences between the two domains. It is beneficial for both asset managers and their service providers to understand these barriers and how they differ from corporate tax so that they can be prepared to address them as they arise.

Absence of an organisational mandate. Within the global corporate tax environment, tax authority transformation, centralised global decision making, finance transformation, global system implementations and shared services are all driving tax departments to transform their operating and delivery models. Meanwhile, in the asset management fund tax environment there is little evidence to suggest that these forces are as strong or even evident. Instead

of being overtly planned or part of a wider strategic picture, fund tax teams appear to be responsible for a wide variety of tasks and often have to respond quickly to dynamic forces ranging from fund structuring to regulatory compliance and investor reporting. This results in a more patchwork or ‘get-it-done’ approach to delivery.

Back-office perceptions of fund tax compliance.

Historically, fund tax departments within the asset management industry have been seen as a back-office function that can add little value other than fulfilling reporting obligations. Unlike the corporate sector, fund managers often do not recognise that fund-related tax or investor reporting has a meaningful effect on their bottom line. Accordingly, our research suggests that those responsible for compliance and reporting in the asset management industry are generally more junior, have less experience and are less influential within their organisation. Compliance decision-makers are less likely to be agents of change or to have the budget or mandate to implement transformational change.

Reliance on third parties. When comparing responses from the corporate survey to the asset management survey, it became clear that internal responsibility for compliance and the procurement of associated services is less consistent in the asset management sector than in global corporates, where there is invariably a global tax director and a team of regional reports. The research suggests that there is less consistency in terms of the functions taking responsibility for compliance and a fragmentation of responsibility from fund to fund, making central and senior decision-makers harder to find. The organisation of service delivery and procurement of services is consequently more fragmented, devolved, informal and ad hoc.

Comparison of Business Drivers

Driver	Corporate tax model	Fund tax model
Call to action	Overtly planned	Just-in-time
Resources	Strategic outsourcing	Default outsourcing
Risk Priorities	With regulators and tax authorities	With investors
Adding value	Bottom line tax savings	Back office

Urgency and expediency. While the growth and pace of change in the asset management industry suggests a potential opportunity for change in compliance and reporting, those responsible for compliance and reporting tell us that there is rarely time to stand still and plan for the longer term. This may perpetuate a less structured and more ad hoc approach.

Need for flexibility. Our research participants indicated that existing supplier arrangements with respect to compliance often remain with the service provider that supported the tax structuring of an individual product. Convenience and inertia are major factors and there is perhaps a feeling that the specific expert knowledge applied to structuring will be carried through to compliance. As asset managers establish new fund types and investments, they are well aware of the need to retain the flexibility necessary for choosing 'best of breed' advisers on a case-by-case basis. This often results in a proliferation of service providers when it comes to compliance and reporting delivery.

Motivation and opportunities for change

Despite these known barriers, the results of our asset management research clearly show that fund tax departments do have an appetite for change and a desire to transform their operating model into something more similar to that of their corporate counterparts. This model is accepted as potentially more effective and of value to each organisation.

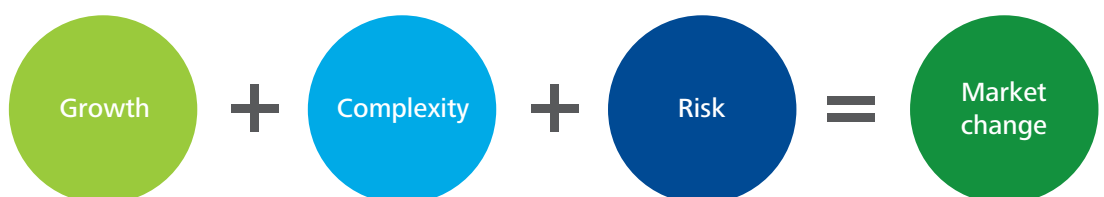
An industry-wide focus on investor expectations, cost control, global regulation and increased attention from tax examiners may be the catalyst needed to initiate change. These forces, which can be grouped into three key drivers, provide a prime opportunity for fund tax teams to redesign their operating model to bring greater value to their asset management firms.

Growth. There are a variety of arrangements in place along the continuum with no clear optimum operating model for fund tax, but a common thread suggests that outsourcing is the default option. However, the significant and rapid growth of the asset management industry will stretch capacity, expose vulnerabilities and challenge fund tax departments to control costs if an ad hoc approach to procurement and service delivery continues.

Fund tax teams might look to their corporate tax counterparts for guidance on creating a more consolidated outsourcing model to achieve better centralisation and economies of scale. The road ahead may compel fund tax teams to consider a thorough review of their service providers as well as to rationalise and simplify supplier arrangements.

Growth cannot be achieved without significant investment in processes and technology. Fund tax teams will need to make the case for one or multiple technology and process improvement solutions in line with their goals to increase the centralisation of their business model, take a longer term view of cost management and deliver greater value.

Complexity. With growth comes increasing complexity in the way asset managers do business. This second driver of change will challenge fund tax departments to get more creative in their market offerings and investor reporting, while continuing to manage obligations, risks and responsibilities. New products in new jurisdictions are expected and there is significant potential for asset management firms to differentiate themselves from the competition through clearer, sharper and faster investor reporting.

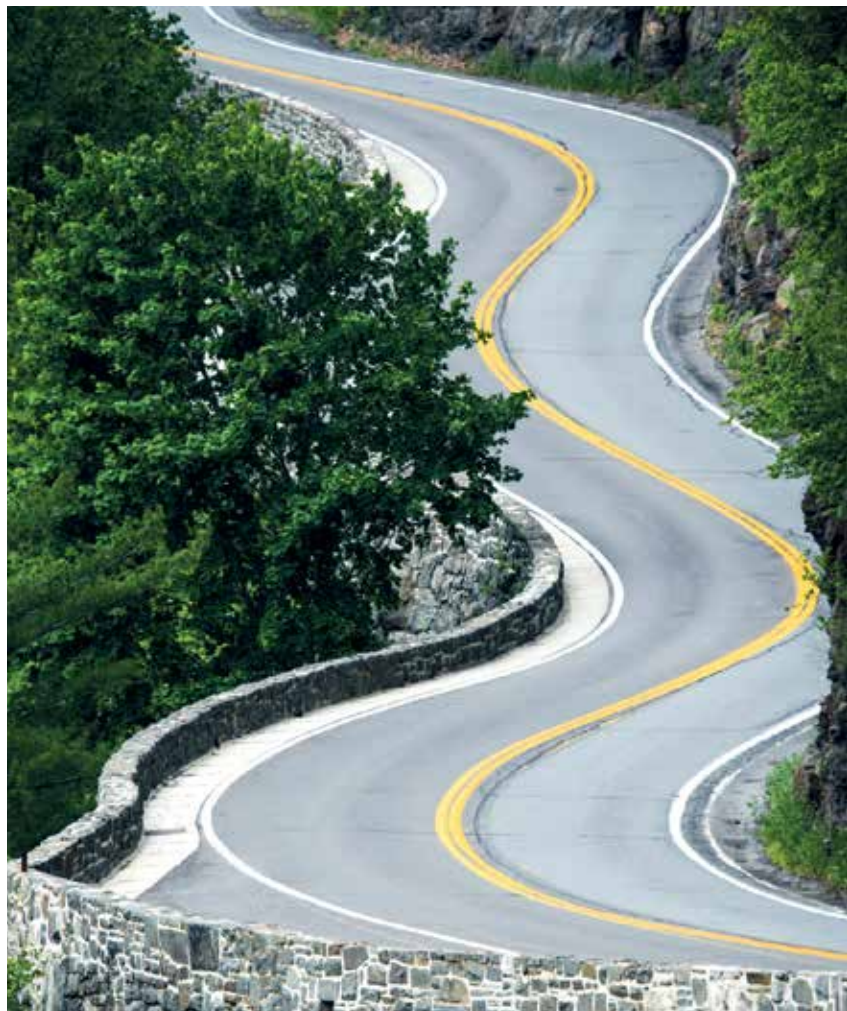


As asset managers establish new fund types and investments, they are well aware of the need to retain the flexibility necessary for choosing ‘best of breed’ advisers on a case-by-case basis

Investment in technology has the potential to deliver improvements in both the efficiency and management of more complex business operations. Asset management firms and fund tax functions that are able to recognise the potential and choose to implement technology solutions may have a significant head start in addressing the demands of a more complex regulatory environment and more sophisticated investor reporting needs.

Risk. Rapid growth and added complexity are typically barometers for increased risk. Asset managers often identify external risks in a number of areas, mapping them on a low to high spectrum. Whereas corporate tax departments tend to focus their energies on complying with global regulations and keeping tax authorities happy, fund tax departments are hyper-aware of their investor-related, reputational risks. Current arrangements and operating models mean that tax departments often do not have the capacity to devote much attention to risk management, inhibiting their ability to focus on this issue. They also outsource much of the regulatory and tax authority risk to their third parties with little oversight.

As fund tax teams take action to move to a more centralised operating model, they should be able to achieve better oversight, become less defensive in their approach to risk management, and address the opportunity to add value for their investors through increased transparency, product offerings and reporting services.



The road ahead

The larger, more established asset management firms have indicated that they have already started to mirror the more centralised operating models of their corporate tax counterparts and are now seeing the value that their fund tax teams can add. They have adjusted their mindset, broken through many of the barriers to change and are generally better positioned to lead the market through this transitional period. This does not mean that the smaller—and perhaps more agile—firms cannot initiate these changes, but it will certainly take a focused and methodical approach to break through the barriers that currently exist for fund tax teams.

However, with this time of impressive growth comes a different kind of risk. As asset managers expand their service offerings in new jurisdictions to an increased base of investors, there is more investor reporting to be done, more regulations with which to comply and more tax authorities to appease. As a result, the same risk factors that are driving growth become the first areas to be monitored and addressed as asset managers make changes to the way they do business.

A balance of innovation with careful planning and continual reassessment will be critical to a successful transition to a more centralised model. Having the right advisers, service providers, technology and internal checks in place can help to determine an appropriate model that will meet the expectations and needs of all stakeholders.

In the third article of this four-part series, we will continue to explore the growth of the industry by focusing on risk management and how asset managers and their service providers can appropriately plan and oversee their work and inspire confidence in their employees, investors and regulators all over the world.

To the point:

- Compliance and reporting in the asset management industry shares some characteristics with the corporate environment, but its mission, value drivers and current resourcing models are vastly different
- Although corporate tax departments are further along the evolutionary continuum, asset managers and their tax teams are showing signs of a movement towards greater consolidation, centralisation and visibility in their delivery models
- Asset managers want to reap the benefits of better processes, technologies and global capacity, but will be looking for this from their service providers
- Managing global risk will be the watchword as the industry expands both in size and in complexity





New challenges in interest rate derivatives valuation

Simple is not just simple anymore

Guillaume Ledure
Manager
Advisory & Consulting
Deloitte



In the past, the valuation of plain vanilla swaps has been a rather simple problem, taught in finance classrooms

However, since the occurrence of the financial crisis, counterparty credit risk has become of paramount importance in derivatives valuation. This has led to a completely renewed valuation framework where what used to be simple has now become complex and what used to be complex is now... extremely complex.

This article deals with derivatives valuation, focusing on one of the most standard derivative contracts used in financial markets: the Interest Rate Swap (IRS). To understand how the credit crisis fundamentally affected the swaps market, it is necessary to understand how it used to work before the crisis occurred.

The classical framework

The 'classical' framework refers to what we learned as students in finance classrooms. It refers to how derivatives markets used to behave prior to the financial crisis of the late 2000s and consequently how financial engineers used to value derivatives in this context.

The valuation of an IRS in the classical framework follows the so-called 'discounted cash flows' procedure. With this method, the value of a swap is equal to the sum of the present values of all future cash flows (paid or received). Floating cash flows indexed on Libor are first estimated by computing the forward (Libor) rates. All (fixed and floating) cash flows are then multiplied by their corresponding discount factors.

The key information required in this process is the yield curve used for discounting the cash flows and computing forward Libor rates. This yield curve does not, per se, represent market observable data. In fact, it has to be mathematically built (calibrated) to be consistent with the market prices of liquidly quoted instruments (deposit rates, futures, forwards, swap points, etc.). In other words, considering IRS, liquid swaps are used to build the yield curve so that other non-quoted swaps can be valued consistently. As an example, in EUR, standard IRS exchange annual fixed payments against semi-annual payments indexed on 6M Euribor.

Stylised facts of the crisis

The credit crisis started around mid-2007. Prior to this, the absence of credit risk in interbank borrowing was implicitly assumed. In other words, banks in the Libor panel were assumed to be of excellent credit quality, so that there was no doubt about the creditworthiness of any Libor borrower.

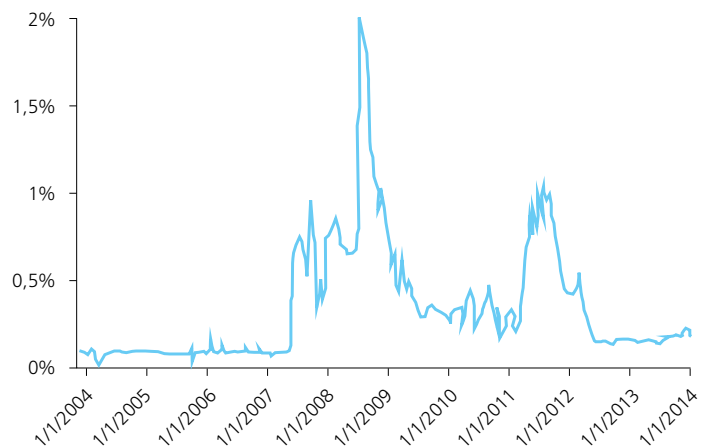
The crisis started when market participants realised this assumption was fundamentally incorrect. Historical time series of various market observables exhibit this phenomenon.

We illustrate here (see figure 1) one of the most salient market features: the spread between 3M Libor rates and the rates of 3M Overnight Indexed Swaps (OIS). This spread is often seen as a measure of credit risk premiums in the interbank market. Firstly, the floating payments of an OIS are equivalent to daily compounded overnight investments, i.e. investments that are considered as nearly risk-free due to their extremely short term (less than one day). Secondly, Libor deposits represent for the lender unsecured investments with a non-negligible term. As can be observed, the Libor-OIS spread used to be close to 0 prior to 2007, spiked due to the credit (2008-2009) and Eurozone sovereign debt (2011-2012) crises and is now back to more stable levels, yet notably higher than what it used to be before 2007.

The Libor-OIS spread denotes the level of reluctance of an investor to deposit for 3M in an AA-rated bank, in comparison with a risk-free investment. This spread level measures the risk for the bank of being downgraded within 3M. The pre-crisis levels close to 0 confirm the above 'no-risk' assumption made at that time.

Other market observable parameters exhibit the same kind of behaviour. Among others, basis swap (i.e. IRS where both legs pay floating coupons of different tenors and payment frequency) spreads also exhibited nearly zero levels before the crisis and increased dramatically since mid-2007.

Figure 1: 3M Euribor - EUR OIS spread



Source: Bloomberg

The 3M Libor-OIS spread denotes the level of reluctance of an investor to deposit for 3M in an AA-rated bank, in comparison with a risk-free investment

The 'Multi-Curve' framework

Libor-OIS and basis swap spreads are two examples of market observables drastically modified by the credit crisis. The consequence of these mutations for derivatives dealers is significant: their usual valuation framework no longer works, in the sense that it no longer matches the market prices of quoted derivatives. For instance, if calibrating the yield curve to market prices of OIS, valuation of standard IRS does not fit market prices; if calibrating the yield curve to standard IRS, valuation of basis swaps does not fit market prices, etc.



Clearly, the classical framework where one single yield curve fits all instruments' market prices in a same currency is no longer valid. A new pricing framework is necessary, with several different yield curves for each currency, each calibrated to a class of instruments. The construction of all these curves results in a gigantic optimisation problem involving all at once all available market instruments in any currency.

To be more specific, let us illustrate the process, starting with the EUR currency. A first yield curve can be calibrated using standard IRS. It is denoted 'Euribor6M' since standard IRS in EUR are indexed on 6M Euribor rates. A second yield curve can be built using OIS and is denoted 'Eonia', following the name of the overnight rate in EUR. A third yield curve, 'Euribor3M', can be calibrated using 3M-6M basis swaps, with Euribor3M and Euribor6M curves used respectively for each leg. Similar treatment can be applied to build e.g. 'Euribor1M' and 'Euribor12M' curves. The situation becomes even more complex when dealing with Cross-Currency Swaps (CCS) where both legs are denominated in different currencies. Consistency is therefore required between valuation of CCS and of mono-currency instruments.

In summary, the credit crisis and the realisation that interbank borrowing is not risk-free results in a strong complication of financial engineering techniques.

Discounting and collateralisation

The Multi-Curve framework described above is a complex mathematical construction but does it make sense after all? In particular, considering two different swaps that each pay a same future cash flow, their present values using two different curves will be different. Is this intuitive?

The reality today is that no strict answer exists for this question. At least some consensus exists in a particular case, where swaps are collateralised.

Generally speaking, swaps embed some counterparty credit risk, since counterparty default can occur on the next expected payment. The risk is still reduced since the exposure is limited to the difference between the next coupons to be exchanged. Nonetheless, the collateralisation mechanism has been created to prevent (at least, strongly reduce) counterparty credit risk and is more and more widespread in swaps markets. Under collateralisation, a transaction is daily marked-to-market and the counterparty with a negative value posts liquid assets (ideally cash) in collateral to compensate the loss of the other party in case of default. Daily adjustment of the collateral position ensures counterparty credit risk is very limited, since in case of default, the remaining party is left with an exposure equivalent to a one-day variation of mark-to-market.



Collateralisation has the advantage of reducing the counterparty credit risk of a swap position at nearly zero. In such a situation, any future cash flow should be discounted at some 'risk-free rate'. In other words, we should have a 'risk-free yield curve' at our disposal, used for discounting of any cash flow of a collateralised swap. The consensus today is that this discounting yield curve must be the one calibrated on OIS (e.g. the Eonia curve in EUR). We mentioned above that OIS rates can be considered as nearly free of credit risk. In practice, discounting future cash flows in a collateralised swap using the OIS curve is even more justified since posted collateral actually generates some interest, more precisely daily compounded overnight interest. As a consequence, discounting using the OIS curve is justified because it is equivalent to the interest received on collateral. The questionable assumption that OIS is risk-free is finally not even necessary.

To summarise the situation of collateralised swaps, future cash flows discounting must be made using the OIS curve while forward Libor rates computation must be performed using the ad hoc Libor curve (given the required tenor: 3M, 6M, etc.). Calibration of all these curves follows the process described above starting with the OIS curve. It is made possible since all swaps

quoted in the market are assumed to be collateralised. What to do then with respect to discounting in non-collateralised swaps? Here, no consensus exists and research is still ongoing on the subject.

Various authors argue that each bank should discount future cash flows with its own funding curve, i.e. the OIS curve shifted by the bank's funding cost. Theoretically speaking, such a framework is flawed as it does not allow for two counterparties with different funding costs to agree on a same trading price. On top of that, this framework is opposed to a long-established principle in finance that the evaluation of an investment should depend on the risk of the investment and not on the way it is funded. Other authors argue that the best estimate of counterparty credit risk is provided in Libor quotations. As a consequence, they advise discounting using the Libor yield curve corresponding to the cash flow tenor (i.e. the same curve as for forward estimation). A third research avenue consists in developing a valuation framework for 'defaultable' swaps, where each instrument is a weighted sum between a risk-free instrument and the amount recovered in case of default.

The Dodd-Frank and EMIR regulations

American and European authorities both tried in recent years to push derivatives markets towards collateralisation of OTC transactions. As shown above, collateral has the advantage of clarifying the valuation process (and what some call the 'discounting dilemma'). More precisely, Dodd-Frank and EMIR regulations aim at the mitigation of counterparty credit risk by the creation of Central Counterparties (CCP). A CCP intervenes as intermediary in a swap transaction and requests significant collateral amounts from both parties. Initial as well as daily variation margins are requested in order to reduce counterparty credit risk. In case of default of one party, the accumulated margins and the high level of capitalisation of the CCP prevent contagion to other parties. Besides, regulations also impose the inclusion of a Credit Support Annex (CSA), a document that describes in detail the collateralisation terms and conditions, for transactions that are not centrally-cleared by a CCP.

Despite its obvious advantages, collateralisation also has some downsides. In a nutshell, it requires complex daily operations for management of the current collateral positions counterparty per counterparty, mark-to-market of the derivatives transactions, daily margin calls and resolution of valuation disputes with counterparties. Operational risk on these processes is thus significant. Collateralisation is also never perfect. Due to the requested operational treatment, collateral posting does not occur beyond certain thresholds. In other words, posted collateral never, in practice, perfectly matches the mark-to-market of the positions; residual counterparty credit risk remains.

Collateral management also covers more complex issues such as 'netting' and 'rehypothecation'. Netting refers to the possibility of considering the aggregated exposure of all open transactions with a counterparty in the collateral management. Intuitively, it is common sense but it still requires heavy operational treatment. Rehypothecation, however, refers to the possibility of using collateral posted by a counterparty for meeting its own collateral obligations. On the one hand, it is a fair mechanism to prevent large capital requirements to meet all collateral needs but, on the other hand, it may induce contagion of defaults across counterparties.

To the point:

- Valuation of interest rate derivatives, even the most simple ones like plain vanilla IRS, has now become complex due to the growing importance of counterparty credit risk
- Matching the market prices of quoted derivatives requires the use of a Multi-Curve valuation framework, where yield curves used to value different instruments are different, and where several curves may be necessary to value a single instrument. All these curves should be built consistently with each other in a large optimisation problem. Today's experts have not yet even reached a full consensus on how to deal with these complex issues in practice
- Transaction collateralisation has become of paramount importance and is strongly supported by current regulations. However, it is accompanied by an increased operational complexity and new technical issues

Glossary

- **The London InterBank Offered Rate (Libor)** is the average interest rate estimated by a panel of AA-rated banks in London that they estimate they would be charged if borrowing from other banks. Libor is calculated every day at 11.00 a.m. UK time for different borrowing terms (1D to 12M). 'Euribor' is a similar standard related to the EUR currency for banks in the Eurozone.
- **An Interest Rate Swap (IRS)** is a financial derivative instrument in which two parties agree to exchange interest rate cash flows, based on a specified notional amount from a fixed rate to a floating rate (usually Libor).
- **An Overnight Indexed Swap (OIS)** is an IRS where the periodic floating rate is equal to the geometric average of an overnight rate (i.e. with 1D term) over every day of the payment period.
- **The discount factor at maturity T** is the present value of 1 currency unit paid at the future date T .
- **A yield curve** is a continuum of discount factors for all future points in time. It may be implied mathematically from the observed market quotations of various interest rate derivatives.
- **The forward Libor rate** is the estimate (under no-arbitrage assumptions) of the Libor that will be observed for a future payment period. It is calculated directly from the appropriate yield curve.



Investment opportunity

A market perspective on the changing securities lending landscape

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The recent financial crisis has been, without doubt, one of the most challenging periods for the global economy in the history of modern finance. Even so, investors are still seeking to enhance returns on their investment portfolios, given the specific risks inherent in these investments. One of the opportunities in enhancing the portfolio return is to utilise securities lending.

Financial markets went through major changes over the past decade: investments considered relatively safe defaulted, large international investment banks filed for bankruptcy and European governments failed to meet capital requirements. Still, investors seek to maximise returns on their investment portfolios.

Securities lending

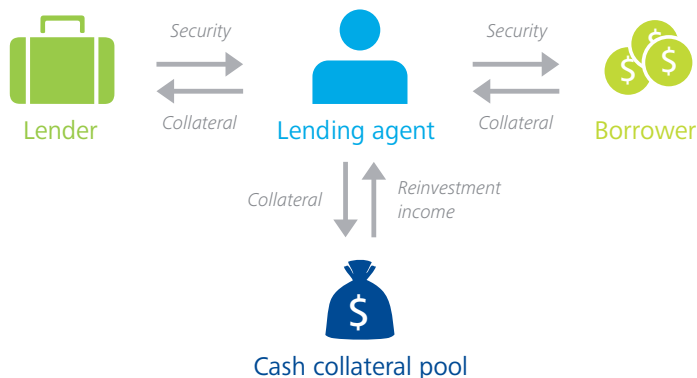
Securities lending is the market practice by which, for a fee, securities are transferred temporarily from one party (the lender or beneficial owner) to another (the borrower). Borrowers want to own securities for a certain period for a variety of reasons, including covering a short position and enhancing settlement efficiency. The vast majority of securities lending is executed by a securities lending agent (figure 1). Pension funds and insurance companies are typical lenders of securities since they hold large, relatively stable asset portfolios. The reason lenders make their securities available is to generate additional returns on their portfolios. Returns can be generated from both the loan fee from the borrower and any return from cash collateral reinvestment.

Market developments

Securities lending arose in the 1960s in the UK as an informal practice among brokers who had insufficient share certificates to settle their sold securities. During the 1970s and 1980s, it evolved into the market practice it is today. The market continued to develop during the first decade of the 21st century, but since 2008, the year earnings peaked and Lehman Brothers defaulted, returns have been deteriorating.

When Lehman Brothers (itself a significant securities borrower) defaulted, the ensuing crisis in the securities lending market created severe liquidity stress. In some cases, securities lending agents were forced to return cash collateral—which had been reinvested in illiquid assets—to borrowers, resulting in losses on the lending side.

Figure 1: Agency securities lending transaction



The losses and liquidity stress were typically commensurate with the degrees of credit risk and liquidity transformation associated with the investment of cash collateral. Asset-liability mismatches were created by excessive speculation in cash reinvestment in what could have otherwise been a relatively safe activity. The collapse of Lehman Brothers forced many financial institutions to review their lending programmes, resulting in a range of measures, from introducing more conservative guidelines to drastically scaling back or suspending lending activities. Another reason has been the host of short-selling regulations appearing and disappearing, which have resulted in investors temporarily suspending their participation in the lending market, fearing they may contravene short-selling bans.

The crisis struck at the heart of financial markets and slowed securities lending activities significantly, on a global scale, where it decreased 56% (figure 2) in 2014 as compared to the pre-Lehman period. Another major consequence of the global financial crisis is the shift from cash collateral to non-cash collateral (figure 3) as institutions now require non-cash collateral to avoid reinvestment risk, as some participants have

suffered significant and unexpected losses due to cash reinvestments in instruments riskier than the loaned securities. Securities lending improves overall market efficiency and liquidity, supports a variety of trading strategies and general financing techniques and can help facilitate the timely settlement of securities.

The Dutch pension sector is considered one of the largest and most developed pension fund industries in the world and has traditionally been very active in securities lending. The activity decreased significantly more in the Netherlands as compared to the global decline after Lehman.

Tax considerations

Transfer tax consequences depend largely on the country in which the security is issued. There is nothing standard about the way in which a particular tax is levied and the amount a party to the transaction must pay. For instance, a country may levy a tax on each individual security transferred, while another country may exempt the transaction from tax if parties can demonstrate that it is part of a group of transactions that constitute a securities lending transaction.

Figure 2: Increase/decrease securities lending

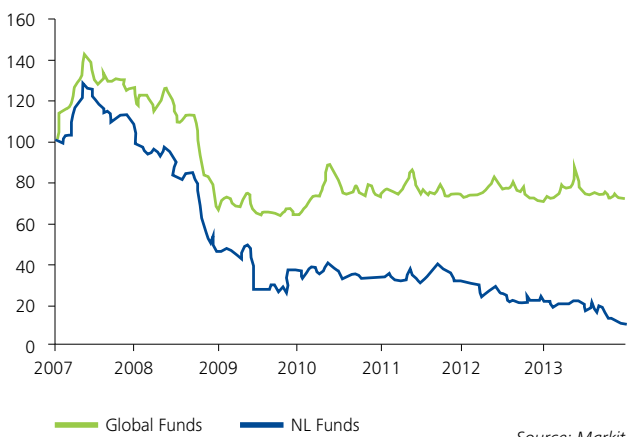
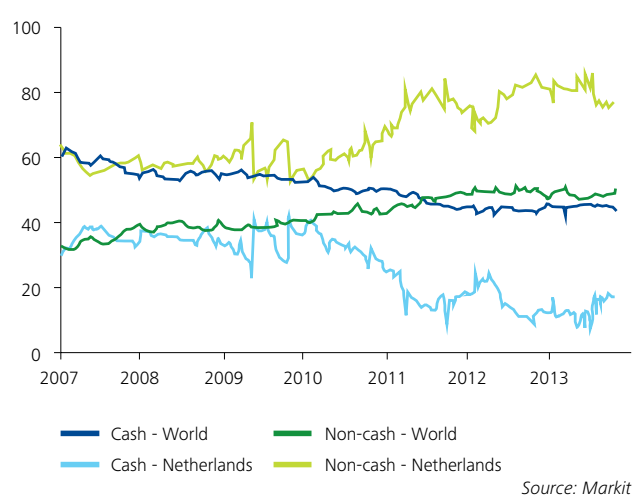


Figure 3: Cash vs non-cash



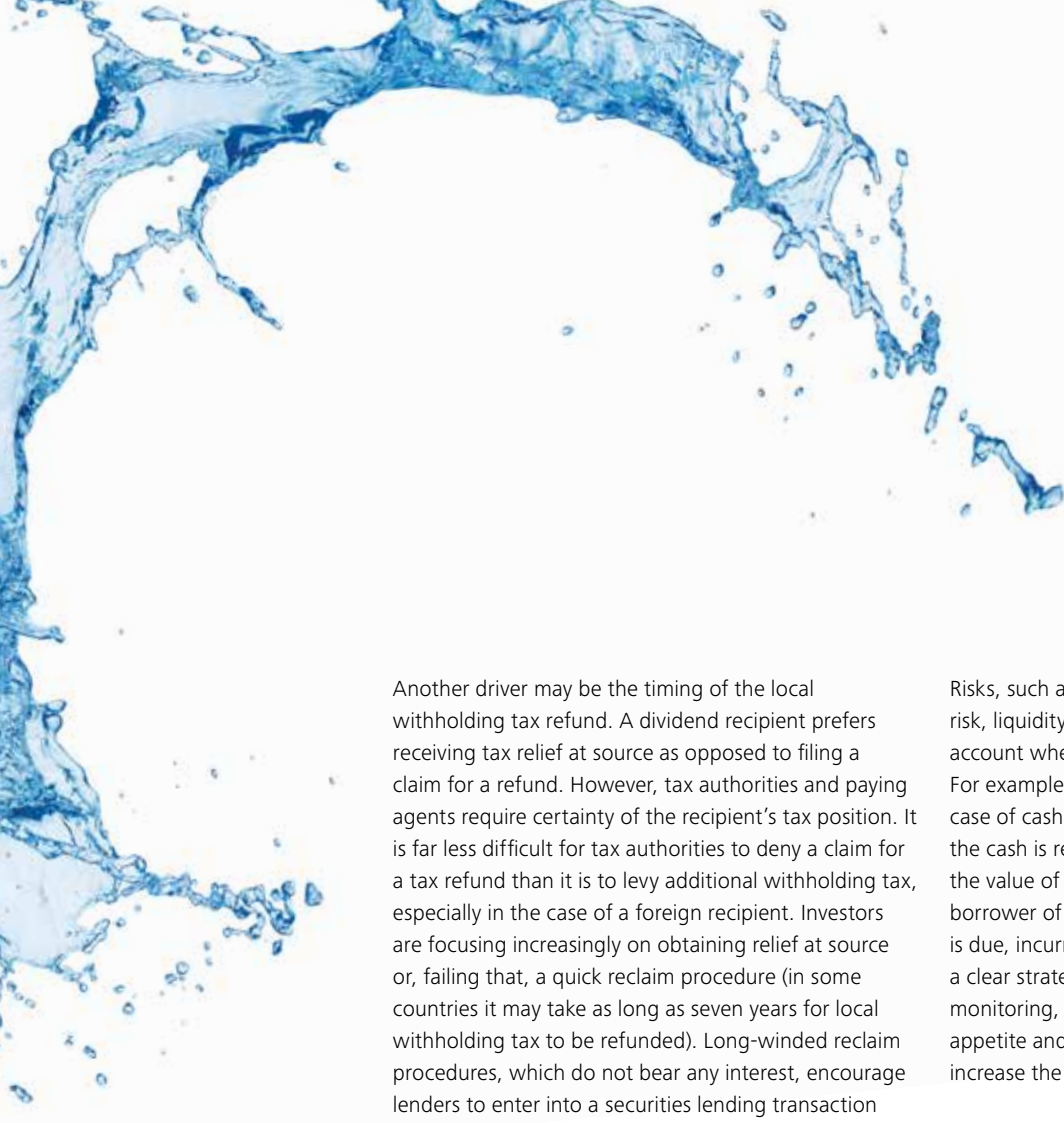
Another type of tax that indirectly affects a securities lending transaction is the withholding tax on interest and dividends. In a securities lending transaction, the legal title transfers from the lender to the borrower. As a result, the holder of the legal title of an equity security has the right to receive the dividend. This means the lender will not receive the dividend income he would have received if he had not entered into the securities lending transaction. To resolve this, it is common for the borrower to reimburse the lender with a manufactured/ substitute dividend, so that the lender is effectively remunerated in the same way he would have been had there been no securities lending transaction. This is where withholding tax comes in. Dividend withholding tax is usually levied on the account of the security's legal owner. In other words, the borrower receives the dividend, but also incurs dividend withholding tax. When both parties to a securities lending transaction determine the substitute dividend, both the borrower and the lender consider the fact that dividend withholding tax may be levied. Therefore, parties need to establish how best to deal with this tax issue when arranging the securities loan.

Market data typically show an increase in securities lending volumes during periods when companies pay dividends. This implies that tax plays an important role in securities lending. Securities lending is a way of optimising withholding tax payments. Becoming involved in dividend trading may deter investors from entering into securities lending programmes, but is this theory correct? Let us assume that a lender would normally receive a dividend on a certain type of security at a withholding tax rate of 15%. Accordingly, the lender may choose to lend securities at the market rate (i.e. the amount that borrowers are willing to pay to hold the securities beyond the dividend date, expressed as a percentage of the gross dividend). If the prevailing market rate is, say, 90%, the lender would receive 85% in substitute dividends and 5% in fee income.

The Dutch pension sector is considered one of the largest and most developed pension fund industries in the world and has traditionally been very active in securities lending

This scenario demonstrates that the lender is potentially better off entering into a securities lending agreement than keeping the securities beyond the dividend date. A lender typically has a schedule of the net dividends that the lender would receive if the securities were not on loan and only lend when market levels are greater than this level.





Another driver may be the timing of the local withholding tax refund. A dividend recipient prefers receiving tax relief at source as opposed to filing a claim for a refund. However, tax authorities and paying agents require certainty of the recipient's tax position. It is far less difficult for tax authorities to deny a claim for a tax refund than it is to levy additional withholding tax, especially in the case of a foreign recipient. Investors are focusing increasingly on obtaining relief at source or, failing that, a quick reclaim procedure (in some countries it may take as long as seven years for local withholding tax to be refunded). Long-winded reclaim procedures, which do not bear any interest, encourage lenders to enter into a securities lending transaction as it is an effective way to effectuate immediately the tax rate to which the lender is entitled. It seems the changing landscape is offering opportunities for securities lending transactions.

Market data typically show an increase in securities lending volumes during periods when companies pay dividends

Risks and opportunities

Although securities lending is designed to be a relatively low-risk activity, it has not been wholly immune to the economic crisis. Recent market events have reminded lenders of securities that securities lending has a specific risk and return profile and should be evaluated on the basis of the risks inherent in the specific structural characteristics of each lending programme, just like any other investment decision. However, lenders may mitigate securities lending programme risk by carefully planning, executing and managing their participation in a lending programme.

Risks, such as counterparty credit risk, reinvestment risk, liquidity risk and tax risk, have to be taken into account when deciding on programme parameters. For example, cash reinvestment risk is the risk that, in case of cash collateral, the value of the assets in which the cash is reinvested fluctuates and may drop below the value of the cash that needs to be returned to the borrower of the securities at the time such repayment is due, incurring a loss for the lender. By combining a clear strategy of securities lending with continuous monitoring, securities lending can match the risk appetite and investment attitude of lenders seeking to increase the returns on their portfolios.

Supervision and monitoring

Internationally, securities lending is a crucial issue for policy makers. Nevertheless, most regulations have yet to be finalised. Regulators are focusing increasingly on transitioning from firm-specific supervision to global rules, affecting all market participants.

The UK's Financial Stability Board performs an important coordinating role in the regulation of securities lending. In August 2013, the FSB published a final document on 'Strengthening oversight and regulations of shadow banking'. This report sets out recommendations categorised into three groups, in accordance with the nature of the recommendations: improvements in regulatory reporting and market transparency, the regulation of securities financing and improvements in the structural aspects of the securities lending market.

The recommendations could result in an increase in disclosure and minimum margin requirements. In the Netherlands, the supervisory authority (The Dutch Central Bank) is currently working on regulations to improve the control of securities lending risks. Currently, very few regulatory changes are specifically directed at lenders such as pension funds. However, many of the new proposed liquidity rules for banks and other securities lending agents under Basel III indirectly affect them.

“A carefully thought-out approach to running a securities lending programme helps to enable the beneficial owner of the security to extract the intrinsic value and liquidity inherent in a portfolio. By combining a clear strategy with continuous monitoring, securities lending can match the risk appetite and investment attitude of lenders seeking to increase the returns on their portfolios.”

James Day, Managing Director Global Collateral Services, BNY

As with other types of investments, lenders should continually monitor their securities lending programmes to ensure they achieve their objectives and stay within the expected risk profile. The monitoring of a securities lending programme should encompass three main areas:

1. The monitoring of lending activities should include counterparty creditworthiness, counterparty concentration, the market value of securities on loan, the lending agent’s financial condition and company-wide exposure to various counterparties
2. Collateral monitoring should consist of the cash collateral investment strategy, the securities purchased with cash collateral, the investment guidelines and the securities collateral
3. Performance measurement should cover investment return, the core drivers and the risks taken. Various metrics should be reviewed within each area through reporting, due diligence reviews and ongoing communication with the lending agent

Conclusion

After the 2007-2008 financial crisis, the dynamics of the securities lending market changed dramatically. The global market activity decreased significantly and observed a shift from cash to non-cash collateral. Lenders have become more conservative, more discriminating in the choice of collateral in the case of non-cash collateral, and they have improved their understanding of the risks involved. By taking into account the risks and changing market environment, following a clear securities lending strategy and continually monitoring the programme, security lending can be managed according to the lenders’ risk appetite and investment beliefs, increasing the return on their portfolios.

To the point:

- Securities lending activities have decreased on a global scale by more than half, as compared to before the collapse of Lehman Brothers
- The characteristics of securities lending have changed significantly. Collateral has shifted from cash to non-cash and risk aversion has increased. Still, securities lending is generating market liquidity and improving market efficiency
- Securities lending has evolved into a collateral management technique, and a risk monitoring programme should be set up to remain in control of the different risks
- By combining a clear strategy of securities lending with continuous monitoring, securities lending can match the risk appetite and investment attitude of lenders seeking to increase the returns on their portfolios

New tax regulations impacting investment funds

Austria Luxembourg Spain

At a time when new tax regulations are redefining the investment management industry, it is important to reflect on these upcoming changes and the consequence to the industry in the context of intense international pressure. The below articles present and analyse the impacts and repercussions of these new tax regulations in Austria, Luxembourg and Spain, which is of significant relevance for foreign asset managers and private banking clients.





Austria

New tax reporting scheme for Austrian funds

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The new tax reporting scheme could bring tax advantages for investors but might require funds or their administrators to provide Austrian tax representatives with a wider range of tax relevant information. The new rules will further have significant impact on the interaction between the OeKB and the Austrian tax representatives of funds. Furthermore, a new withholding tax will be applicable to specific foreign investors on Austrian interest income as part of taxable income from funds as of 1 January 2015.

On 5 May 2014, the Austrian Ministry of Finance (AMF) and the Austrian Kontrollbank (OeKB) presented the new tax reporting scheme for domestic and foreign mutual, real estate and alternative investment funds in Austria.

The new reporting scheme will amend the reporting process between Austrian tax representatives of the investment funds and the OeKB. In particular, the following processes will be implemented:

- **Reporting of the tax bases for the calculation of the capital yield tax (KESt)** on deemed distribution income and the distributions by the Austrian tax representatives of domestic and foreign funds in Austria to the OeKB
- **Calculation and dispatch of the relevant tax amounts for the purpose of the KESt by the OeKB** to the Austrian tax representatives for sign-off

within the reporting deadline (seven months after business year-end for KESt on deemed distribution income and one day before distribution day for KESt on distributions)

- **Publication of the taxation of distribution income and distributions deemed taxable** for several types of Austrian investors (individuals and legal entities, private foundations) on the homepage of the OeKB

The new reporting process will not result in effective changes for the calculation of the distribution income and distributions deemed taxable.

However, the number of reporting codes that Austrian tax representatives have to dispatch will substantially increase. Currently there are six mandatory and an additional nine optional reporting codes for the reporting of distribution income deemed taxable. There are also four mandatory and an additional five optional reporting codes for the reporting of distributions. In future, however, funds might be required to provide about 60 mandatory codes, which are different for mutual, real estate and alternative investment funds.

The AMF and the OeKB might reduce the number of mandatory codes in order to avoid massive zero reporting in case specific mandatory codes do not apply to the respective fund and to limit the anticipated administrative burden on tax representatives, funds and administrators.

The amended tax reporting scheme should become applicable for **business years starting after 31 December 2014 at the latest**. Accordingly, the current tax reporting scheme will be applicable due to a draft ruling issued by the AMF on 17 July 2014 for reporting of distribution amounts and distributions deemed taxable **referring to business years which start before 1 January 2015**.

The new reporting scheme will amend the reporting process between Austrian tax representatives of the investment funds and the OeKB

Furthermore, the AMF announced in the above-mentioned draft ruling that interest income as defined under the regulations for the European withholding tax in the European Union Savings Directive (EUSD) which qualifies as Austrian interest income is subject to 25% capital yield tax (KESt) if derived by specific foreign tax residents after 1 January 2015. Foreign tax residents who hold a custody account in Austria and are **individuals resident in a non-European country—and corporations resident outside Austria**—and not subject to the regulations of the EUSD as applied in Austria will be subject to the new capital yield tax. Funds planning to report the relevant interest income daily and as part of the annual deemed distribution income, or as part of distribution, may report the relevant KESt figures to the OeKB until 14 November 2014. The OeKB will then publish a list with the funds planning to report the interest income and the KESt thereon.

New reporting codes will have to be applied for the daily, annual and distribution reporting. The daily figures will have to be reported **by the fund** or its administrator to the OeKB, the annual reporting and the distribution reporting will have to be effected **by the Austrian tax representative of the fund to the OeKB**.

The above-mentioned new KESt reportings are optional and have nothing to **do with the tax reportings for Austrian investors**. If a tax transparent or reporting fund decides not to report the new KESt figures relevant for foreign investors, the tax transparent status for Austrian investors will remain. In this case if a foreign investor (as described above) holds shares in a fund with an Austrian depository bank, 25% capital yield tax will be deducted on a lump sum tax base. The investor is entitled to credit the tax against the tax in



The amended tax reporting scheme should become applicable for business years starting after 31 December 2014 at the latest

his home country and claim for a refund of the non-creditable part of the capital yield tax in Austria due to the applicable Double Taxation Treaty, unless there is no relief at source in Austria, with respect to which the AMF has announced that it will publish further regulations.



Luxembourg

Implementation by Luxembourg of the standards for the transparency and exchange of information for tax purposes

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By way of introduction, there are three different methods for exchanging information:

- **On request (on demand):** A State shall request from another State to provide information on a case-by-case basis.
- **Automatic:** States shall automatically exchange agreed information (income, frequency, format, etc.).
- **Spontaneous:** A state shall without prior request forward to another State information of which it has knowledge under a number of circumstances.

Luxembourg takes actions at both international and European levels to apply the different types of exchanges of information.

1. Luxembourg's actions to become compliant with the OECD's Global Forum on Transparency and exchange of Information for Tax Purposes

As reported in the media, in November 2013 Luxembourg received a non-compliant rating from the Global Forum on Transparency and Exchange of Information for Tax Purposes (hereafter 'the OECD's Global Forum').

You will find hereafter the Luxembourg actions to become compliant. Luxembourg will ask for reassessment as soon as possible on the basis of the new measures and laws under way. For the sake of completeness, you will first find a few words on what the OECD's Global Forum is.

Set up in the early 2000s, the OECD's Global Forum is a multilateral framework in connection with the tax transparency and exchange of information. The forum is one of the largest tax groups in the world with more than 120 member States (both OECD and non-OECD economies). The OECD's Global Forum conducts peer reviews to assess members' jurisdictions on their level of compliance with internationally agreed standards for the exchange of information.

The peer reviews are currently organised into phases as follows with regard to the exchange of information on request:

- **Phase 1:** this phase focuses on the legal and regulatory framework
- **Phase 2:** this phase focuses on the efficiency of the system in place
- **Phase 3:** this phase ensures continuous monitoring of implementation of the exchange of information (starting in 2016).

Following phases 1 and 2 of the peer reviews, members receive ratings on the availability of information, access to information and exchange of information, as well as an overall rating.

In 2011, Luxembourg successfully passed phase 1. As stated by the Luxembourg government, the assessment was carried out soon after the 2009 political decision to introduce the OECD standard provision on the exchange of information on request in double taxation treaties and the active period of time during which Luxembourg negotiated with many countries to include this provision in double taxation treaties.

In 2013¹, Luxembourg received a non-compliant assessment as an overall rating after phase 2. It should be noted that phase 2 covered the period from 2009 to 2011, which matched the setting up of the new standard concerning the exchange of information on request².

The first answer is in connection with the identification of owners of bearer shares. The other answers are in connection with an effective exchange of information for tax purposes with other States.

Mechanism to identify the owners of bearer shares

Shares of some companies (SA, SE, SCA) may be issued in bearer form. Under the previous regime, the holders of those shares were not identified in the register of shareholders of these companies.

The OECD's Global Forum concluded that: *"although there are parallel mechanisms that ensure the availability of the information in specific situations, there is no overall obligation to identify the holders of bearer shares under all circumstances"*.

In line with the OECD expectations, Luxembourg proposed a new regime to ensure the availability of information relating to bearer securities holders³.

The key points of this new regime as from August 2014 are:

- Bearer shares continue to exist. Entities, including investments funds, which have issued/will issue bearer shares will have to deposit them with a depository
- The depository should be a Luxembourg professional as listed in the law implementing the regime (credit institutions, qualified lawyers, chartered accountants, etc.)
- The evidence of their ownership will be established by registration in the share register kept by the depository



¹ During the session held in Jakarta in November 2013, the OECD's Global Forum adopted ratings for the first 50 jurisdictions on their level of compliance with the internationally agreed standard for exchange of information

² The law of 17 March 2010 implemented effectively in the Luxembourg legislation the new standard of exchange of information on request. Nevertheless, taking into account the period of time required to ratify a double taxation treaty, most of them entered into force as from 2011 (http://www.impotsdirects.public.lu/conventions/conv_vig/index.html)

³ Law of 28 July 2014 on immobilising bearer shares and bearer securities



- Management of the Luxembourg entities concerned may incur fines if it does not respect the new regime

As from the entry into force of the new regime in August 2014, existing bearer shares will be:

- Cancelled if not deposited within 18 months
- Subject to suspension of their voting rights and dividend rights attached if not deposited within 6 months

Implementation of the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters

On 29 May 2013, Luxembourg signed the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters. Currently, more than 60 countries have signed this mutual agreement⁴ (more than 20 countries signed during 2013).

This convention will enter into force for Luxembourg on 1 November 2014.

The convention is a multilateral agreement designed to facilitate international co-operation and collection of taxes between States.

It provides for all possible forms of administrative co-operation between States Parties in the assessment and collection of taxes:

- Exchange of foreseeably relevant information for taxation purposes in three ways: on request, spontaneously and automatically
- Tax investigations, including participation in tax investigations abroad
- Assistance in recovery, including conservatory measures
- Service of documents

In connection with the automatic exchange of information, States Parties are not able to directly exchange information on the basis of this convention. Two or more States Parties will agree separately on what and how they will exchange automatically. The OECD is developing a common standard for automatic exchange of financial account information. On 21 July 2014, the OECD released the first edition of this common standard. Luxembourg is committed to implementing this global standard swiftly.

Double taxation treaties concluded by Luxembourg

Luxembourg continues to negotiate double taxation treaties including the OECD standard provision on exchange of information on request.

New Luxembourg legislation dealing with the procedure for the exchange of information on request

The OECD's Global Forum recommended, inter alia, that: "*Luxembourg should review its interpretation of the foreseeable relevance concept to conform with the standard. Luxembourg should exercise its powers to compel production of information and apply sanctions as appropriate.*"

⁴ As mentioned in the OECD Information Brief on the Multilateral Convention (November 2013) "the Convention was developed jointly by the OECD and the Council of Europe in 1988 and amended by Protocol in 2010. The Convention is the most comprehensive multilateral instrument available for all forms of tax cooperation to tackle tax evasion and avoidance, a top priority for all countries. The Convention was amended to respond to the call of the G20 at its April 2009 London Summit to align it to the international standard on exchange of information on request and to open it to all countries, in particular to ensure that developing countries could benefit from the new more transparent environment. The amended Convention was opened for signature on 1st June 2011. The Convention has now taken on increasing importance with the G20's recent call for automatic exchange of information to become the new international tax standard of exchange of information"

On 31 December 2013, the Luxembourg tax authorities issued a Circular providing the interpretation they will follow on some concepts relating to the exchange of information on request:

- The concept of 'information that is foreseeably relevant'⁵
- The principle of non-retroactivity⁶
- The non-selectivity of data to be provided to the Luxembourg tax authorities⁷

The Luxembourg tax authorities also stipulate in this Circular how they will request information depending on the residency of the person concerned⁸.

This tax Circular is in line with the OECD's latest comments dated 17 July 2012 on how to interpret the provision on exchange of information on request.

Moreover, the Luxembourg government submitted to the parliament a draft bill on the procedure for the exchange of information on request⁹.

The key points of the draft bill are the following:

- The procedure would apply to all requests for the exchange of information on request received from another jurisdiction under one of the various international tax agreements to which Luxembourg is stakeholder, such as a tax treaty, the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters (please see above) and

The Luxembourg government submitted to the parliament a draft bill on the procedure for the exchange of information on request⁹

laws transposing the 2010 European Directive on mutual assistance for recovery and the 2011 European Directive on administrative co-operation in the field of taxation (please see below)

- The Luxembourg tax authorities would be obligated to verify only whether a foreign jurisdiction's request is formally in line with the applicable treaty or law. If so, the Luxembourg tax authorities would execute the foreign request by sending an injunction notification to the data holder for the requested information. The foreign request would be viewed as confidential and could not be disclosed to the data holder
- The data holder would be obliged to provide the Luxembourg tax authorities with the information requested in its complete form, without alteration, within one month of the injunction notification. If a document to be provided contains data connected with a third party, such data should not be hidden. Failure to comply (refusal to provide information within one month or alteration of the information) could result in a penalty of up to €250,000

5 The exchange of information should concern information that is foreseeably relevant ("vraisemblablement pertinents"). This is the limit to avoid the fishing expedition. Luxembourg mentions in the Circular that they will not reject a foreign State's request in case the likely relevant information can be examined following receipt of the information from the person concerned. Once the requesting State has given an explanation concerning the "foreseeably relevant" information requested, Luxembourg should not refuse a request or provide information requested because the Luxembourg authorities estimate that the information is irrelevant for the underlying examination or investigation

6 Double taxation treaties concluded by Luxembourg are often applicable as from 1 January of the calendar year following the year in which the Convention entered into force. However, the principle of non-retroactivity does not stand against the passing on of data from year(s) prior to the coming into force of the Convention, as long as the data to be passed on are relevant to determine taxable income in respect of the tax year covered by the Convention. Please note that the Circular refers to the applicable penalty in case of data holder's refusal to provide the requested information (a fine up to €250,000)

7 The data to be passed on to the Luxembourg tax authorities by the data holder, in order to comply with injunction decisions issued by the LTA following information requests from foreign tax authorities, must be provided in a complete form and with no alteration whatsoever. In case the data holder does not provide information requested in a complete form or alters the content of information to be provided, the Luxembourg tax authorities should impose a penalty up to €250,000

8 The tax circular targets three situations:

- Should the person concerned is resident in Luxembourg, the Luxembourg authorities will send the request directly to this person
- Should the foreign tax authorities do not want the person concerned to be informed of the request, the request will be addressed directly to the data holder
- Should the person concerned by the process is resident in Luxembourg but does not receive the request or he/she is non-resident in Luxembourg, the request will be addressed directly to the data holder

9 Draft bill no. 6680

- The requested data would be able to include data from prior to the entry into force of an applicable treaty or law, provided that the requested data is foreseeably relevant in determining the income tax base for a year following the entry into force of the treaty or law

In case of urgency or where the notification is likely to undermine the chance of success of an investigation conducted by the requesting jurisdiction, the Luxembourg competent authority would be able to prevent a data holder that is a credit institution, and its directors or employees, from disclosing the existence and contents of the injunction notification to the client or taxpayer concerned. Otherwise, the data holder could be subject to a penalty of up to €250,000.

- The procedural rules applicable before the courts would differ from the usual rules, to accelerate the treatment of requests for exchange of information on request (i.e. the period of time to file a claim before the court would be shorter, judges would be required to issue a decision in a specific timeframe, etc.).

The Luxembourg parliament must now review, discuss and, if necessary, modify this draft law before it can be approved.

2. Luxembourg's action in connection with FATCA

On 28 March 2014, Luxembourg and the United States signed a Model I FATCA Intergovernmental Agreement (IGA) (IGA type 1 is based on reciprocity and automatic exchange of information) and a Memorandum of Understanding (MOU) to improve international tax compliance between both jurisdictions.

This agreement will be followed by a procedure of Parliament approval in Luxembourg in the last quarter of 2014 before being transposed into local legislation.

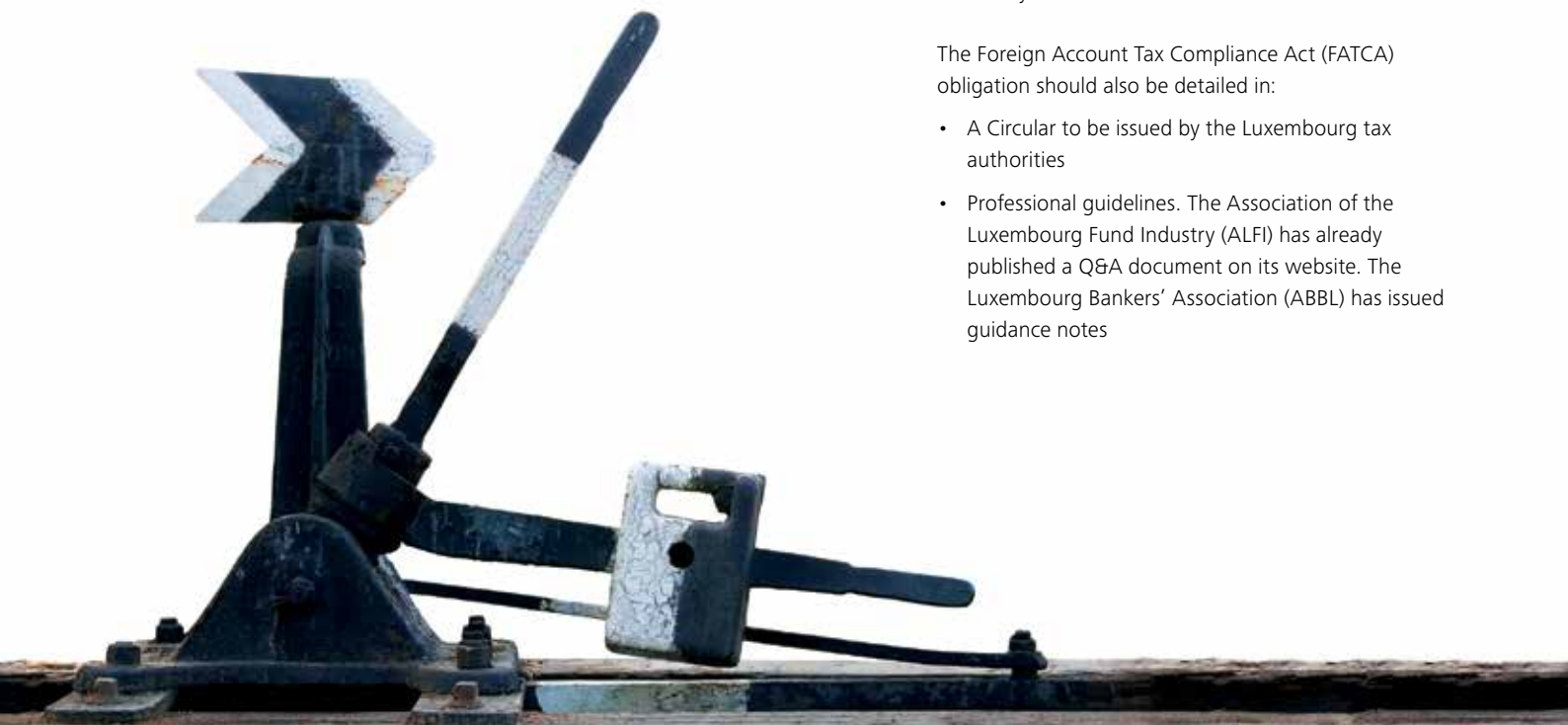
On the basis of this agreement, the U.S. and Luxembourg tax authorities will automatically exchange information on assets of (I) U.S. citizens and (II) residents of the U.S. held by financial institutions in Luxembourg.

Based on article 3 of the IGA (Time and Manner of Exchange of Information), the information will be exchanged by Luxembourg within nine months of the end of the calendar year to which the information relates.

Following the Luxembourg government communication, the first exchange of information is planned before September 2015 applying to the financial year 2014¹⁰.

The Foreign Account Tax Compliance Act (FATCA) obligation should also be detailed in:

- A Circular to be issued by the Luxembourg tax authorities
- Professional guidelines. The Association of the Luxembourg Fund Industry (ALFI) has already published a Q&A document on its website. The Luxembourg Bankers' Association (ABBL) has issued guidance notes



3. Luxembourg's actions at the European level

At the European level, the actions are in connection with the European Directive on administrative co-operation and the European Savings Directive.

European Directive 2011/16/EU on administrative co-operation in the field of taxation

EU Directive 2011/16/EU aims to strengthen tax co-operation between EU member states and organise the three methods for exchanging information (upon request, automatically and spontaneously).

The Luxembourg law of 29 March 2013, transposing EU Directive 2011/16/EU, introduced the exchange of information upon request and the spontaneous exchange of information as from 1 January 2013.

The Luxembourg law of 26 March 2014 transposed the remaining portion of EU Directive 2011/16/EU in connection with the automatic exchange of information between EU member states on specific types of income¹¹.

On the basis of this legislation, as from 2015 and for tax periods beginning 1 January 2014¹², Luxembourg will automatically provide information on three types of income: salaries, directors' fees and pensions and annuities.

In June 2013, the European Commission proposed to extend the scope of the exchange of automatic information under this Directive to additional types of income (dividends, capital gains, royalties, etc.). This is still a proposal waiting for the political consent of all EU member states. Nevertheless, taking into account the current position on the Savings Directive (see below), the scope of this Directive could be extended in the near future.

Currently, 26 member states exchange information automatically under the EUSD Directive

European Savings Directive

The EU Savings Directive (EUSD), which has been applicable since July 2005, requires EU member states to exchange information automatically about interest payments made by paying agents located in one EU member state to individual recipients (and to specific types of entities, called 'residual entities') resident in another member state.

Currently, 26 member states exchange information automatically under the Directive. Two member states—Austria and Luxembourg—still apply a 35% interest withholding tax as an alternative to the automatic exchange of information (unless the beneficial owner of the payment requests the paying agent to exchange information automatically in lieu of the withholding tax). Several 'third countries' (such as Switzerland) and 'dependent and associated territories' (such as the British Virgin Islands, Cayman Islands and Channel Islands) apply similar or equivalent measures (i.e. an interest withholding tax or automatic exchange of information measures).

¹⁰ Answer of the Luxembourg Finance Minister of 28 July 2014 to the parliamentary question n°378

¹¹ Five types of income are concerned: (I) salaries, (II) directors' fees, (III) pensions and annuities, (IV) ownership of and income from immovable property, and (V) life insurance products not covered by other EU legal instruments on exchange of information and other similar measures

The EU Directive requires each EU Member State to select income on which the State will automatically exchange information with other EU Member States

¹² The exchange of information will be performed on a regular basis (i.e. at least once a year). Luxembourg commits to provide information for any given year by 30 June of the following year at the latest. For example, for information concerning fiscal year 2014, information would be provided by or before 30 June 2015



An amended version of the EUSD has been in the EU legislative pipeline since 2008 (and adopted by the EU Council on 24 March 2014). The amendments aim to close loopholes identified under the current Directive. In order to maintain the level playing field between the EU member states and the 'third countries' (Andorra, Liechtenstein, Monaco, San Marino and Switzerland) that have implemented equivalent measures to the current Directive), the EU Commission has requested that these five countries update their agreements with the EU to reflect the revised scope of the amended Savings Directive and to commit to implement, as early adopters, the new single global standard for the automatic exchange of information developed by the OECD and endorsed by the G20.

Luxembourg announced in 2013 that it will unilaterally move from imposing the 35% interest withholding tax to automatically exchanging information for EUSD purposes from 1 January 2015.

Luxembourg will automatically exchange information with other EU member states on interest (as defined in the currently applicable EUSD) paid to individuals and residual entities with a permanent address in the EU, and with those dependent and associated territories having reciprocity clauses in their bilateral savings taxation agreements concluded with Luxembourg.

On 18 March 2014, the Luxembourg government submitted to parliament a draft bill to implement the necessary changes into Luxembourg tax law¹³. The first

exchange of information due date under the draft bill is 20 March 2016 regarding calendar year 2015.

On 20 March 2014, Luxembourg and Austria dropped their opposition to the adoption of the amended EUSD (as sufficient guarantees were provided as to maintaining the level playing field with the above-mentioned third countries). As mentioned above, the amended Directive was adopted by the European Council on 24 March 2014 and includes the following changes to the current Directive:

- All types of regulated investment funds investing in debt claims will be covered by the Directive. In practice, this means that non-UCITS (part II) SICAV, SIF-SICAV and SICAR funds will fall within the scope of the Directive
- Certain life insurance products will be covered (such as certain unit-linked life insurance contracts), subject to grandfathering rules for contracts subscribed before 1 July 2014
- The definition of residual entities will be extended to include all EU entities that are not subject to effective taxation (the definition under the existing Directive is more restrictive). In practice, payments made to a broader range of entities, trusts, foundations and similar legal arrangements within the EU will become reportable (such as payments to a German KG, UK LP, Dutch Stichting and trusts in several member states)
- Look-through rules will apply to payments made to blacklisted entities, trusts, foundations and similar legal arrangements outside the EU (such as Bermuda trusts, Hong Kong private limited companies, Panama foundations, etc.)

EU member states must transpose the amended EUSD into their domestic law before 1 January 2016, and it will apply as from 1 January 2017.

Luxembourg development regarding the EUSD are linked to the adoption of the automatic exchange of information as a new standard at the G20 level, and also to other initiatives such as FATCA, the EU mutual assistance directive on administrative cooperation, the OECD Convention on Mutual Administrative Assistance in Tax Matters and the corresponding common reporting standard on automatic exchange of information.



Spain

Tax update

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In June 2014, the Spanish government unveiled a draft tax package that has been presented to the parliament in August 2014. The tax package is expected to set the tone for a major reform of the Spanish tax system, which is currently limited to direct taxes. In this respect, the announced changes refer mainly to Personal Income Tax (PIT) and Corporate Income Tax (CIT), but there are also measures aimed at promoting and improving tax compliance.

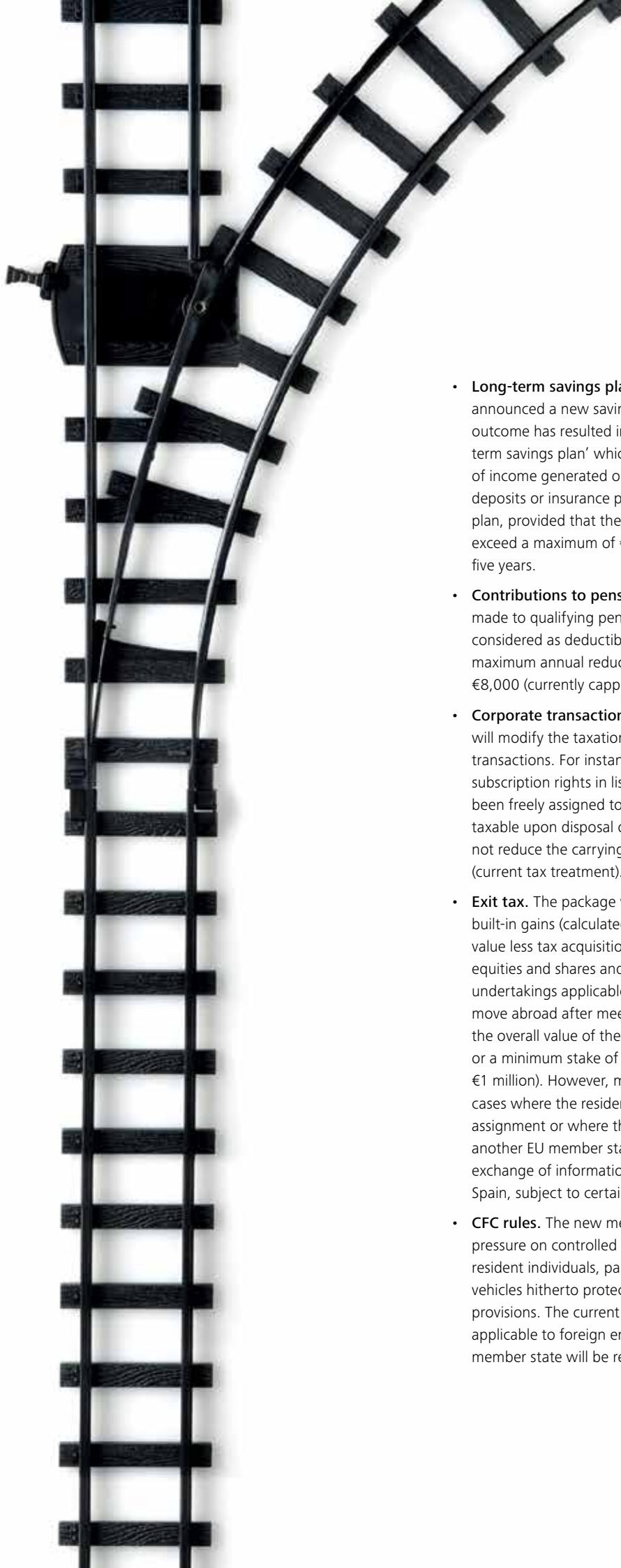
Most of the proposed tax changes will be effective as of 1 January 2015, although there are certain transitional measures and exceptions. There is currently a certain level of uncertainty on whether all the draft measures will be eventually passed into law, since subsequent amendments may be introduced by parliament. There is, however, a reasonable expectation that a number of the announced measures will be introduced in a similar form as that presented in the current draft.

We summarise below some of the proposed measures that we believe may be of relevance for the asset management industry, focusing on investors subject to PIT:

- **Tax rates.** The current basic structure of PIT will be maintained and a 'dual tax base' will apply with different tax rates applicable to the 'general tax base' and to the 'savings income tax base'. The top rate applicable to the 'general tax base' will fall from 52% to 47% for 2015 and to 45% for 2016. However, the income threshold to reach the new marginal maximum will be significantly lower (cut from €175,000 to €60,000). The savings income tax rate will be reduced from 27% to 24% in 2015 and subsequently to 23% in 2016. Additionally, the savings income top threshold will be increased (from €24,000 to €50,000).
- **Short-term capital gains.** Under the current law, capital gains derived from the sale of an asset generated in one year or less must be computed in the 'general tax base' and subject to the top marginal rate according to the applicable scale,

whereas only capital gains derived from the sale of assets held for more than one year can be included in the 'savings tax base'. The draft tax package changes this rule and as of 1 January 2015 capital gains and losses will be included in the savings tax base regardless of the holding period of the asset.

- **Income/loss setoff.** The proposed reform will introduce some flexibility in the rules applicable to the offsetting of interest income and capital gains/losses included in the savings part of the taxable base, allowing the setoff of income/losses derived from bonds and other income-producing assets with gains/losses derived from investment in shares and participations in equities and investment funds, subject to certain rules.
- **Dividend threshold exemption.** The new regulation will eliminate the currently applicable exemption to dividends obtained up to a threshold of €1,500. Since under current regulations the dividend exemption is not applicable to distributions made by investment funds, the tax reform will result in the same tax treatment of dividends paid by corporations and by investment funds (i.e. neither of them will be exempt after suppression of the threshold).
- **Capital gain reductions on assets held before 1994.** The tax reform will eliminate the time-based reduction coefficients applicable to capital gains derived from disposals of assets acquired before 1994. These reduction coefficients apply as a result of transitional measures that are still in force and allow for reductions in the amount of taxable capital gains derived from certain long-term held assets. The measure will be in force for disposals made as of 1 January 2015, so according to the published draft, capital gains made during 2014 may still qualify for the reductions under the old regime.



- **Long-term savings plan.** The government had announced a new savings accumulation vehicle. The outcome has resulted in a product called the 'long-term savings plan' which provides for an exemption of income generated on amounts invested in bank deposits or insurance policies that are linked to the plan, provided that the amounts contributed do not exceed a maximum of €5,000 per annum for at least five years.
- **Contributions to pension plans.** Contributions made to qualifying pension plans will still be considered as deductible allowances, but the maximum annual reduction will be capped at €8,000 (currently capped at €10,000 per annum).
- **Corporate transactions.** The new measures will modify the taxation of certain corporate transactions. For instance, the sale of preferential subscription rights in listed companies that have been freely assigned to investors will become taxable upon disposal of the rights and therefore will not reduce the carrying tax cost of the investment (current tax treatment).
- **Exit tax.** The package will impose an exit tax on built-in gains (calculated by reference to market value less tax acquisition cost) on holdings of equities and shares and units in collective investment undertakings applicable to resident individuals who move abroad after meeting certain conditions (e.g. the overall value of the portfolio exceeds €4 million or a minimum stake of 25% plus market value above €1 million). However, mitigation is provided for cases where the residence change is due to a work assignment or where the residence is changed to another EU member state or state with effective exchange of information measures in place with Spain, subject to certain requirements.
- **CFC rules.** The new measures will increase the pressure on controlled foreign entities held by resident individuals, particularly in certain EU-based vehicles hitherto protected under safe harbour provisions. The current CFC safe harbour exclusion applicable to foreign entities set up in another EU member state will be restricted by the reform.

The CFC exclusion will require not only that the foreign entity has been set up for valid business purposes (this requirement is already applicable), but also that the foreign entity is engaged in active business activities. There is a concern that controversy may arise over whether some private investment vehicles set up in other EU countries may now be caught under CFC anti-avoidance measures.

A safe harbour rule will grandfather collective investment undertakings that are within the scope of Directive 2009/65/EC of the European Parliament and of the Council (unless set up in a tax haven).

A safe harbour rule will grandfather collective investment undertakings that are within the scope of Directive 2009/65/EC of the European Parliament and of the Council (unless set up in a tax haven).

- **Tax deferral regime for gains derived from qualifying funds.** Last but not least, the reform will maintain the basic tax rules applicable to Spanish resident individuals investing in resident funds as well as in EU-based undertakings with UCITS status, including the tax deferral regime in case of reinvestment of qualifying gains (known as the 'traspaso' system).

This means that, in the case of the final investor who holds shares or units in harmonised UCITS funds registered for distribution in Spain but deposited in a foreign custody account, the wording of the applicable new regulations on 'traspasos' will be the same as that recently analysed by the Spanish General Directorate of Taxes in ruling V1196-14 of 29 April. This ruling is of significant relevance for foreign asset managers and private banking clients holding assets deposited in custodial accounts outside Spain.

While the ruling recognises that holding assets in custodial accounts outside Spain is not a fact that by itself disallows the potential application of the tax deferral system in Spain, the Spanish tax authorities have set out quite strict requirements in order to apply the deferral regime in this particular context. This places significant importance on the procedures to subscribe/acquire and reimburse/sell the participations of shares and on the role of the Spanish entity acting as distributor of the funds, given that the latter plays a key role in reporting the relevant tax information to the Spanish tax authorities as required by the tax deferral system.

Broadly speaking, the Spanish tax authorities require that the final investor must pass the orders directly to the Spanish distributor. They also require that the Spanish distributor plays a principal, necessary and exclusive role in the transactions with the shares or units in scope. This role must be documented contractually. In order to prevent potential practical loopholes or gaps in the application of the deferral system, the procedure must be designed in a way that makes it impossible to subscribe or transfer the relevant shares without the distributor's involvement and also takes into account special situations such as termination of activity.


The new regulation will eliminate the currently applicable exemption to dividends obtained up to a threshold of €1,500

Foreign banks and asset managers wishing to offer the tax deferral system to Spanish resident clients with assets held in custodial accounts outside Spain are advised to review their current operational procedures and identify whether they are able to structure alternative operational procedures with a Spanish distributor that is compliant with the requirements set by the Spanish tax authorities.

Other relevant highlights are the following:

- The CIT rate will fall from 30% to 28% in 2015 and 25% in 2016. A new Corporate Income Tax Law will be enacted with significant changes in respect of current legislation.
- Wealth Tax and Inheritance Tax are not included in the announced tax package, although they are expected to be included in a broader reform of the tax system (still pending broader political agreement).





Mauritius

An outsourcing jurisdiction in the Indian Ocean

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As fund managers continue to face margin pressures, outsourcing fund accounting and administration to Mauritius can be an attractive alternative.

The global environment

In the wake of the recent financial crisis, the global investment management industry has gone through several paradigm shifts and is now facing new challenges. The industry has been forced to reshape itself and adapt to regulatory measures, client pressures and persistent competition. Reforms are being introduced in financial centres, with governments across the world instituting more rigorous rules and regulations. Clients are demanding quality reporting, with more transparent cost structures and more readily available—as well as knowledgeable—staff. Asset managers are forced to invest massively to implement and comply with new regulations and to respond to increased pressure to provide higher quality and transparent information faster to clients.

To contain costs, asset managers are required to review their operational processes to identify inefficiencies and concentrate on core activities and competencies. In this context, industry players are forced to adapt and scrutinise new boundaries and identify new jurisdictions

with competitive fees and proper regulations that would meet rising expectations on performance and efficiency. In the U.S. and the UK, the outsourcing of back-office operations has become a standard practice. European and Asian investment managers are increasingly turning to outside providers to outsource non-core activities.

Outsourcing decisions can be challenging, but the island of Mauritius has risen to the challenge and has positioned itself to offer a unique value proposition to respond to the industry's expectations.

The numerous advantages of outsourcing business processes to Mauritius

For the past quarter of a century, the Mauritius government, with the required impetus, has provided favourable conditions for the country to develop an international financial services industry that has come to be a reputable outsourcing destination.

The financial services sector is regulated by the Bank of Mauritius (BOM) and the Financial Services Commission (FSC). The BOM is responsible for the regulation of all banking services whereas the FSC is the integrated regulator for non-banking financial institutions and global business. The FSC aims to achieve international standards by simplifying processes and procedures to remove barriers to investment and to facilitate delivery of services.

With the right balance between regulation and business development, both the BOM and the FSC have established the necessary safeguards to promote and ensure the soundness and stability of the financial system, making Mauritius a well-regulated, secure and transparent financial centre. Financial regulation is based on international best practice standards in terms of legal framework and supervision. These standards, combined with an attractive fiscal regime and a wide network of double taxation treaties, make Mauritius a popular destination for international asset managers to set up offshore funds and also to outsource their fund accounting and administration.

Political and economic stability

The political and economic stability of Mauritius are key reasons that provide comfort to asset managers that the country is a safe and trusted location for the conduct of business. The island was recently ranked 8th globally (and 1st out of 46 countries in the Sub-Saharan Africa region) in the Index of Economic Freedom¹. Also, Mauritius was ranked 20 out of 189 economies by the World Bank in 2014 in the overall "Ease of Doing Business".

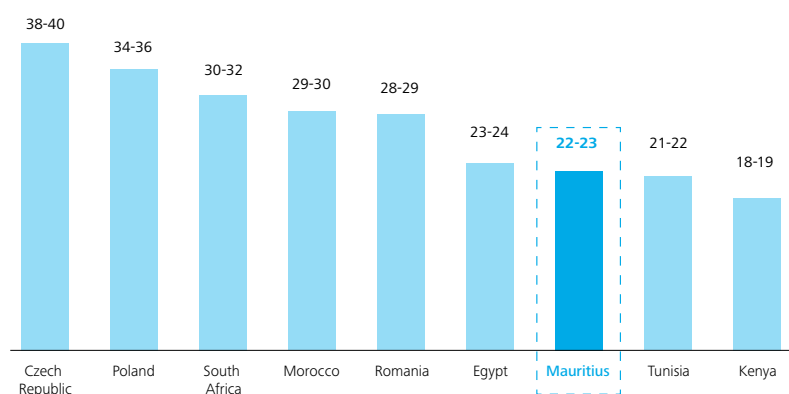
Cost-effective solutions

The cost of service delivery in Mauritius is another significant advantage for fund managers pursuing cost-containment strategies. In fact, based on the cost components of staff and operation costs, administration and accounting fees, and technology costs, Mauritius is a very affordable outsourcing destination. The charts below illustrate the operating costs per full-time employee for financial and accounting services and IT costs across popular outsourcing destinations.

Financial and Accounting (F&A) cost comparison

Direct operating cost per full time employee for transactional F&A services

2012; US\$ 000 per annum per FTE

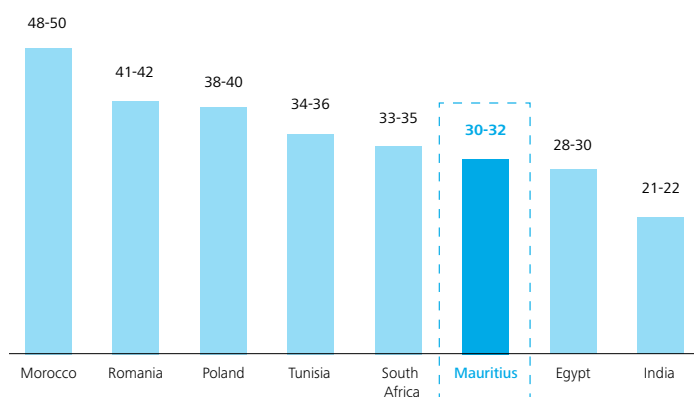


Source: Everest Group (2012)

IT cost comparison

Direct operating cost per full time employee for IT applications development and maintenance

2012; US\$ 000 per annum per FTE



Source: Everest Group (2012)

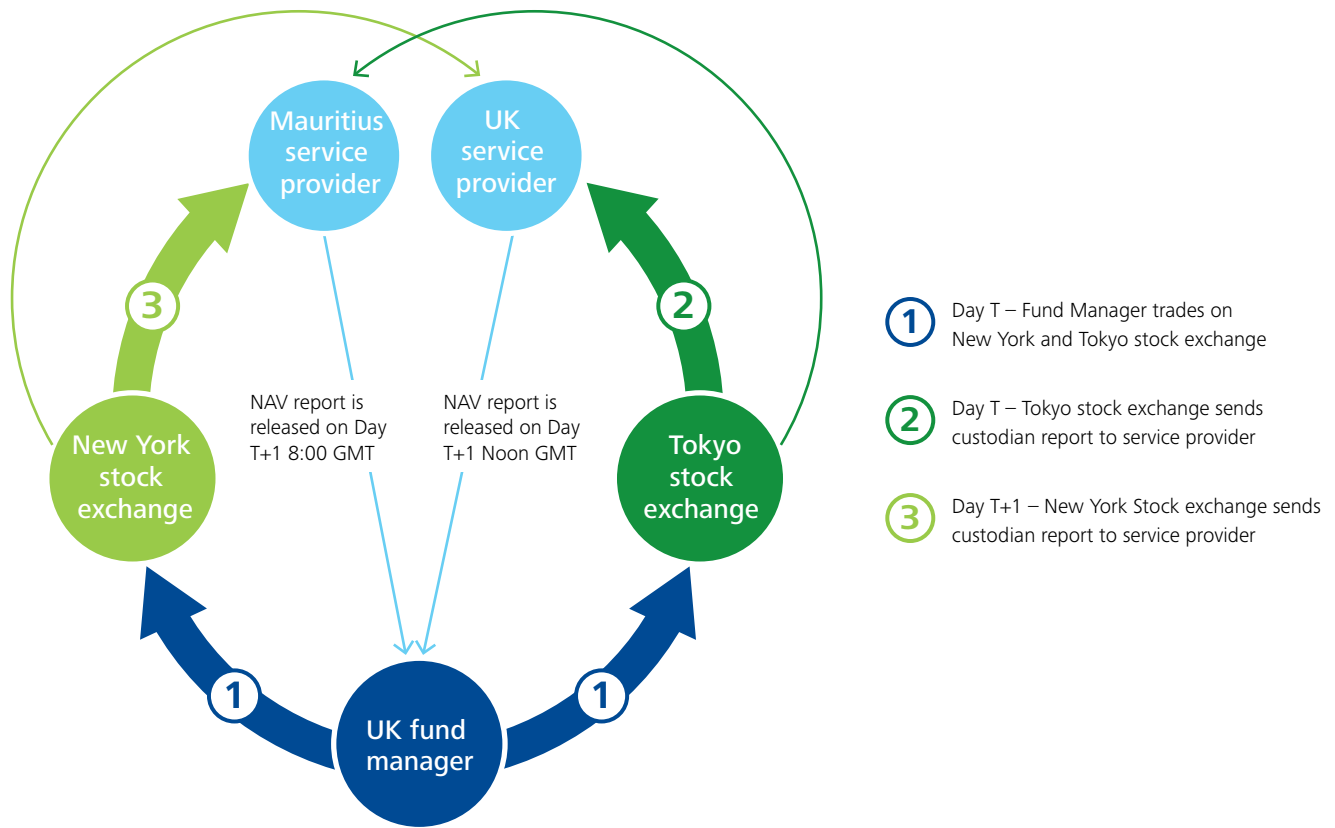
¹ Heritage Foundation (index on trade freedom, business freedom, investment freedom, and property rights) www.heritage.org/index/

Convenient time zone (GMT +4)

Mauritius' advantageous GMT +4 time zone allows business to be done with major markets within a single business day. Outsourcing accounting and fund administration to Mauritius permits fund managers to link trade zones from Far East Asia, such as Hong Kong, Singapore and Tokyo, to the Far West to Europe and the U.S. and also to provide daily pricing as this has become an industry standard.

The following diagram illustrates the NAV calculation processing time between Mauritius and the UK. The UK asset manager would have his NAV report four hours earlier if NAV calculations were outsourced to Mauritius.

NAV calculation processing time



Source: DTOS/Deloitte

Qualified and bilingual professionals

The availability and affordability of qualified professionals, who are bilingual in English and French, also make Mauritius appealing to both French-speaking and English-speaking countries. By virtue of their linguistic proficiency, Mauritian professionals are able to provide value-added services with a customer-centric focus.



Interview with DTOS

by Lissette Rimola-Durieu

Deloitte: Who are your clients? And what solutions are you providing to them?

DTOS has a substantial and diversified client base, which includes Fortune 500 companies, fund managers, family offices and High Net Worth Individuals, who recognise the quality of deliverables that are provided to them.

Our years of experience enable us to understand the challenges and demands of today's fund managers and we have built up our fund services division in terms of personnel, processes and technology in order to respond to our clients' needs. We facilitate the setting up of both private equity and open-ended funds and act as administrator and company secretary to those funds. We can carry out NAV reporting on T+1, finalise accounting statements and provide registrar, tax and compliance services.

Deloitte: Have you seen a significant increase in the number of outsourcing activities to DTOS since 2008? What new services/products have you developed since then?

Indeed, we have witnessed an increase in the number of outsourcing activities in recent years. Clients have chosen to outsource part of their functions to us for a number of reasons such as our track record and experience, availability and professional staff, and quality of services, among others. Since its establishment in 1993, DTOS has continuously reviewed its product offerings to meet our client expectations. Today, our financial outsourcing offer includes accounting and NAV calculation of funds domiciled overseas, journal entry and account reconciliation, payroll processing, as well as debtors and creditors control for local and multinational corporates.

Deloitte: What are the main values that drive DTOS?

At DTOS we value investment in talent, processes and our IT.

We strongly believe in the professional development of our people. We are an Approved ACCA Employer (Platinum) and an ICAEW Authorised Training Employer. We have a team of 160 professionals and provide career development opportunities through sponsorships of employees studying for ACCA, ICSA and ACA qualifications.

We also aim to continuously improve our processes in order to deliver the highest levels of service to our clients. DTOS is one of the few companies in Mauritius that has achieved ISAE 3402 Type II certification.

We have invested massively in a modern IT infrastructure including specialist fund management software.



Deloitte: You mentioned that DTOS makes a significant investment in its IT systems. What measures have you taken to ensure data integrity and security in the integration and restitution process?

We recognise that an efficient and innovative IT infrastructure is a pivotal element affecting a company's performance. At DTOS, we have constantly been investing in our IT infrastructure to keep abreast with innovation, market needs and in support of business projects. Besides housing state-of-the-art infrastructure (advanced hardware and software, high bandwidth connectivity, secure IT connection), we are aware that the IT infrastructure has to offer a secure and trouble-free platform. DTOS IT infrastructure comprises a disaster recovery plan with seamless switch-over technology, a fully-fledged business continuity plan with minimum downtime and off-site connectivity within the group and a dedicated FTP server, hosted in-house, with enhanced security so that clients can upload/download large files securely.

Deloitte: What are the challenges you see facing your clients? What innovative solutions are being provided by DTOS?

Among the various challenges facing our clients, cost containment and higher profit margins are the most challenging ones. Asset managers are finding it extremely difficult to collect and pay higher returns on investments. When looking for their best cost scenarios, clients are also faced with the challenge of having quality services and rapid turnaround time. DTOS understands this new reality and has specialist teams looking at rationalising processes and advising on the most tax-efficient and transparent structures that would ultimately benefit our clients.

To the point:

The financial crisis has accentuated the outsourcing of non-core activities in the investment management industry to contain costs.

Although outsourcing is a complex and controversial issue, Mauritius has established itself as an emerging business process outsourcing destination for fund managers as it provides numerous advantages:

- Political and economic stability
- Financial regulation based on international best practice standards
- Attractive fiscal regime
- Competitive staff and operating costs
- Convenient time zone (GMT +4)
- Qualified and bilingual professionals



About DTOS

Founded in 1993 and licensed by the Financial Services Commission, DTOS provides a comprehensive range of professional services including company formation, corporate and trust administration, fund administration, accounting, tax services, wealth management, third party fund accounting, financial outsourcing and business model optimisation.

DTOS is a subsidiary of Ireland Blyth Limited (IBL), a public company listed on the Stock Exchange of Mauritius. <http://www.dtos-mu.com/>

Target 2 Securities and T+2 Settlement

Challenges and opportunities for the European Fund Distribution

Dominique Valschaerts
Chief Executive Officer
Fundsquare S.A.

Olivier Portenseigne
Chief Commercial Officer
Fundsquare S.A

Chris Prior-Willeard
Chief Executive Officer
BNY Mellon CSD SA/NV

Laurent Collet
Director
Advisory & Consulting
Deloitte

The European trade and post-trade landscape has been dramatically reshaped in the perspective of achieving better financial integration and setting up a single market. According to the European authorities, financial integration leads to enhanced competition and reduces the costs of intermediation, while at the same time allowing to better share and diversify the risks. Target 2 Securities (T2S) is at the core of the European harmonisation project.





The T2S project is slowly but steadily becoming a reality with the first wave of Central Security Depositories (CSD) integrating the new European settlement platform by 2015.

As from 2015 to 2017, 24 European CSDs (within or outside the Eurozone) will connect to the common T2S platform in order to facilitate a more efficient and safer cross-border securities market. T2S aims not only to reduce the cost of settling securities transactions, but also to create collateral savings for market participants. These savings are increasingly perceived as a strategic necessity by market participants at a time when the demand for high-quality collateral continues to rise, as a result of both the crisis and the new regulatory developments.

T2S settlement will be organised in central bank money (starting in euro but other currencies may join afterwards) connecting CSDs, national banks and direct connected participants.

Closely related to the T2S project, the CSD Regulation (CSDR) aims to harmonise both the timing and the conduct of securities settlement in Europe, as well as the rules governing CSDs which operate the infrastructures enabling settlement.

The proposed regulation introduces an obligation on market operators to represent all transferable securities in book-entry form and to record them in CSDs before trading them on regulated venues.

The initial impact of the new CSDR will consist of a common settlement date that will not be later than on the second business day after the trading takes place. T+2 settlement is planned to be harmonised throughout Europe from October 2014.

These structural transformations within the post-trade value chain have a direct impact on the organisation and operations of its major stakeholders. Market infrastructures, custodians and asset managers are currently preparing their new business models in line with these developments.

The investment management industry is also making preparations for this new environment. Would T2S and T+2 represent a new business opportunity? Is it a threat for the primary market distribution? What are the main challenges for the industry? Deloitte Strategic and Operations Director, Laurent Collet, sat down with Chris Prior-Willeard (CEO, BNY Mellon), Dominique Valschaerts (CEO, Fundsquare) and Olivier Portenseigne (CCO, Fundsquare) to discuss these different questions and have a better insight on how the fund distribution can be organised in Europe within a T2S/T2 environment.



Deloitte: How is your company currently preparing for the new T2S environment?

Chris Prior-Willeard

We have been planning for T2S for a long time. In 2010 we identified that T2S would be a powerful driver for change in our business in Europe and included this and other drivers in our immediate change agenda. We have tried to lead the education of the industry and clients on T2S and are active at all levels of the project's governance.

In terms of our preparation, we are actively working towards becoming a Direct Connected Participant (DCP) to T2S, Payment Bank and our CSD is currently in the Wave 4 of the T2S integration plan.

Dominique Valschaerts and Olivier Portenseigne

There is a clear trend and strong will from regulators to push for greater transparency and standardisation of order processing and settlement. For that reason, the post-trade European securities market is poised for more integration to reduce costs and cross-border settlement risks. As a consequence, the European Central Bank has decided to build—and will soon deliver—its T2S infrastructure aimed at creating a single Eurozone security settlement system leveraging on the 28 domestic CSDs.

The two main centres in Europe for cross-border distribution, Luxembourg and Ireland, are set up under a primary market with the dominance of the so-called transfer agent model. Their success is primarily based on their open and flexible model that is able to cope with all kinds of business rules, whether they were set at the level of the product, country of distribution or type of distribution.

When it comes to fund share, T2S will face a certain number of challenges that will have to be answered if it wants to be successful. The major ones are the following:

- T2S will integrate post-trade settlement of the Eurozone, whereas Luxembourg and Ireland are now distributing their funds in more than 55 countries and far beyond Europe. 50% of fund shares are held outside Europe.
- T2S will facilitate settlement for euro-denominated securities, whereas more than 40% of fund shares are denominated in another currency. Would a fund buyer have two or more types of settlement model for funds?
- Fund shares sales, as opposed to any other type of security, are driven by distribution and, as such, fund issuers need transparency of their distribution network in order to monitor their sales effort. So far, T2S is not bringing any solution to solve the transparency issue of the CSD model.
- T2S may solve the issue of settlement but another one still remains: order management remains under a complex model. Indeed, in a primary and cross-border market, each fund buyer needs to reach each fund register and transfer agent individually, which will still bring a high level of complexity and cost.

The two main centres in Europe for cross-border distribution, Luxembourg and Ireland, are set up under a primary market with the dominance of the so-called transfer agent model

T2S will also create a number of opportunities for banks and custodians for streamlining and consolidating their settlement processes in Europe, but also for optimising their collateral and liquidity management. These opportunities may create a clear appetite for banks and custodians to move towards a T2S solution.



These challenges — and at the same time opportunities — are creating a kind of schizophrenia in the fund industry whereby it is so far very difficult to bet on whether there will be more appetite for a T2S model than there was for an ICSD or CSD model today.

Fundsquare, designed as a market infrastructure to facilitate cross-border fund distribution, is currently setting its strategic focus on T2S. And since it will bring both challenges and opportunities, Fundsquare, by its nature, will try to reconcile both the Transfer Agency and the CSD/T2S world through an integration principle bringing the best of both worlds. The future operating model and implementation strategy have been defined but the concrete steps of implementation will certainly bring their obstacles as we try to make these two worlds continue to coexist whilst they may have opposite views, business models and economic interests.

Deloitte: Some key distribution markets (notably France & Germany) have historically attracted foreign funds in their domestic CSD. Do you think that the combined effect of T2S and new depositary requirements will trigger a similar dynamic in other key distribution markets, such as the UK, Italy and Spain?

Chris Prior-Willeard

My view is that there are some significant triggers for this development in addition to those you raise. These include growing enthusiasm for using funds as collateral which requires the traditional fund settlement processes to become closer to those in securities markets. Against this, changes like T2S and the passporting provisions of CSDR will amplify the pace of change towards this goal.

The funds market is investor-driven, so the markets are likely to follow investor requirements for collateral and/or regulatory compliance. The UK is of course different by virtue of not being in the euro and so far not part of T2S.



Dominique Valschaerts and Olivier Portenseigne

France and Germany are historically domestic markets, i.e. having domestic funds distributed domestically despite some attempts to distribute them cross border. That being said and as a matter of fact, cross-border funds that are already distributed in France and/or Germany will de facto be included in T2S. These two very strong domestic markets are served by the two very mature CSDs in terms of fund shares, Euroclear and Clearstream respectively, and will certainly be able to deliver what their respective market expects from an integration into T2S.

UK, Italy and Spain are coming from a different background and history and much more similar to Luxembourg and Ireland, i.e. with a TA-driven model. As a consequence, these markets may not see the same trend as France and Germany, where fund buyers are more used to going directly to the transfer agent or using an ICSD or an intermediary platform.

T2S will increase competition and potential consolidation across CSDs. The key success factor being their ability to provide additional services beyond pure settlement (provided by T2S) such as asset servicing and

The funds market is investor-driven, so the markets are likely to follow investor requirements for collateral and/or regulatory compliance

order management. The success of T2S will be triggered by the fund buyers moving into this model and the added value they would receive. As a consequence, fund buyers will have to perform arbitrage between the settlement efficiency they could obtain via T2S and all the other services they would require through their CSD in order to properly serve their clients. At this stage, looking at the breadth and scope of services provided by ICSD or CSD, there is no optimal model that could meet all requirements in terms of costs vs quality of service when it comes to fund shares.

Our opinion is that the ICSD, CSD/T2S and TA model will continue to coexist in the long run and it is very unlikely that one model will prevail. This is why we are advocating a collaborative model that will reconcile all needs.

The success of T2S will be triggered by the fund buyers moving into this model and the added value they would receive

Deloitte: In your opinion, what are the key impediments to a full deployment of T2S within the European fund distribution landscape? Considering the uncertain evolution of T2S within the European distribution landscape, how is your company positioned with regard to T2S over the next three years?

Chris Prior-Willeard

For full deployment of funds in T2S, fund securities and units will have to be eligible and admitted for settlement in one or more T2S CSDs – in effect transforming them into ‘T2S securities’. This has inevitable consequences for the upstream processing functions.

T2S was not designed with mutual funds in mind. Funds were included later on, and hence T2S processes are not specifically fund-friendly.

Also, the harmonisation of settlement arrangements in T2S has not been extended, for example, to tax, accounting and legal provisions associated with investment funds

Deloitte: How do you see the custody business shaping up over the next few years?

Chris Prior-Willeard

Custody has a few dynamic years ahead as the impact of the post-global financial crisis becomes apparent, such as the new regulations in the U.S. and Europe in particular. New capital rules and the bifurcation between central and commercial bank money are examples of a number of significant challenges to the traditional model. Success in future will demand a degree of agility and flexibility, together with a range of alternatives for clients, to engage directly and indirectly with the market. The BNY Mellon CSD is a direct example of this in practice.

Deloitte: Will the €0.15 settlement cost of T2S influence the current fund pricing model?

Dominique Valschaerts and Olivier Portenseigne

Cross-border fund distribution is a highly intermediated business at every level and as a consequence the €0.15 for settlement may not be the total cost of settlement when you add all the layers playing a role in the settlement process.

Transfer Agents will advocate that settlement into a CSD type of model and more importantly in T2S, will generate new types of costs that do not or did not exist in a transfer agent model for the following reasons: Funds using a TA that is not a bank will have to gain access to central bank money via a third-party clearing bank creating an additional layer of costs.

A delivery versus payment instruction is more expensive than a direct settlement between the Fund/TA and the fund buyer due to the costs of holding a cash and security account at a CSD together with the costs of the instructions.



In parallel, we should not forget that CSDs may not themselves be in favour of T2S as they are outsourcing the settlement to the infrastructure. As a consequence, these same CSDs are losing a large part of their current revenues which they somehow need to recover elsewhere. They may propose a minimum service when it comes to settlement into T2S so that their clients may not move to such a model or propose higher fees for other services.

All in all, whether they are CSD or TA, all these actors may find very good reasons not to cut costs, which will be to the detriment of the fund industry. The buyers of each product and service should then be very attentive to what they pay for the service they get so that T2S could benefit all.

Deloitte: UCITS V, UCITS VI, AIFMD, EMIR, MiFID2 The investment management industry landscape is being redesigned by the regulatory framework. How do you see this landscape in a 2016 horizon?

Dominique Valschaerts and Olivier Portenseigne

The fund industry in general is facing major challenges linked to the current regulatory pressures, the increased competition with other products (ETF, bank and insurance products, domestic products, etc.) and the difficulty of delivering the promise to the market as being one of the unique investment vehicles that should be used for pensions.

As a consequence, we believe that the fund industry as a whole should realise the need for creating a new model and framework in order to be more competitive and cost efficient. Indeed, the cost of distribution and operations is far more expensive than other domestic markets. Even if the models (domestic vs cross-border) are not completely comparable, there is a need to push further for collaboration. There is a clear need also to level the playing field across all players involved in these activities in terms of standardisation and fees, as there is clearly no room nowadays to create value on commodities activities that should be performed in similar ways. Typical examples of activities are KYC, order routing, settlement, registration of funds cross-border, collection and dissemination of fund data and documents to distributors, etc.



Creating such a collaborative and innovative framework and model would enable players to better allocate capital and resources to more added-value services (distribution support, client relationship, new products) that will bring another spin to the competitiveness of the fund industry compared with other industries and will clearly answer regulators' concerns about

transparency, investor protection and their willingness to move funds into an infrastructure type of model as opposed to multiple bespoke models.

Deloitte: What is your response to the stakeholders of the UCIS cross-border distribution that say that T2S/T2 will have no impact on their current business?

Chris Prior-Willeard

Wishful thinking. The genie is out of the bottle. T2S is real and importantly has significant political as well as commercial support. The project is part of a secular change in European markets that has far-reaching ambitions in terms of their international competitiveness. If, as a result of these changes, benefits accrue to beneficial holders, it is a brave man who stands in the way.

Dominique Valschaerts and Olivier Portenseigne

T2S may not impact them in the short term and from a purely operating model perspective as it will be very similar to the current CSD/ICSD settlement models. But stakeholders should keep in mind the spirit of these new initiatives such as T2S or other regulatory changes.

The spirit of these changes is increasing investor protection, transparency and decreasing costs. This means that every actor at every level should start rethinking its business model in order to achieve this bold ambition. The profitable inefficiency concept will not last very long and companies will have to increasingly show value for money.

Deloitte: DTCC has announced and recommended a T+2 and a potential T+1 for settlement cycle including unit trust, while the same products in Europe will continue to be settled on T+3. Is it an opportunity or a threat for Europe? Why do we have such different approaches between the U.S. and EU. What is the UK's perception?

Chris Prior-Willeard

There has been a range of settlement differences between the U.S. domestic markets and virtually every other market in the world. This has much to do with the U.S. advantage in terms of size, scope and depth of their capital markets and at the same time the success of products such as ADRs designed to bridge the differences. However, the differential is narrowing in view of the steady progress towards dematerialisation in the U.S. and the overall application of technology.

DTCC has had ambitions in Europe over a number of years, but as yet this has not produced any significant product other than the recent announcement of some MOUs.

Deloitte: Are the CSDs the ultimate safe place to be in the future? Do we have to put all the securities business in the SSS? As per AIFMD and UCITS V operating a settlement system, recording of securities in a book-entry system through initial crediting; or (iii) providing and maintaining securities accounts at the top tier level should not be considered a delegation of custody functions.

Chris Prior-Willeard

CSDs are inherently safe due to the manner in which they are regulated. The CPSS IOSCO framework, which provides the benchmark against which CSDs are measured, leaves very little to discretion. And even this is likely to be further tightened by the CSD Regulation. So CSDs which use central bank money for the cash leg of a securities transaction have proper governance and an efficient technology platform implementing a comprehensive rulebook which implements the Settlement Finality directive and offers real advantages over some of the traditional interpretations of the model.

Adequate capital and experienced management complete the picture.



To the point:

- The new post-trade landscape will move from a collection of 25 domestic markets to a common level playing field for settlement and collateral management
- Financial institutions have the unique opportunity to revisit their current asset servicing business model, leverage from the regulatory framework and take advantage of the new European market infrastructure landscape
- There will be new opportunities to access different European domestic markets from one counterparty (CSD or custodian) under the new T2S environment
- Custodians are increasingly positioning themselves as one-stop asset servicing providers with direct access to T2S and collateral management services



MiFID II

Changing the distribution landscape

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Who would have predicted Sir Callum McCarthy's Gleneagles speech in 2006¹ would have led to the most radical shake up of retail distribution in the UK, and eight years later largely motivate and inform MiFID II from a retail distribution perspective?



It was one of those ‘I was there’ moments—an epiphany for many—as he made a compelling argument against the inevitable conflicts of commission-led product supply with client suitability. It was of course particularly relevant in the UK, where the Independent Financial Adviser (IFA) channel accounted for a significantly higher proportion of sales than most other European markets, but the principles have now been recognised and enshrined at EU level.

MiFID II covers a huge range of topics beyond distribution. It has been referred to as the ‘paella Directive’ as it took a long time to prepare, has a bit of everything in it and involved too many chefs—but ultimately it should taste good. It requires a thorough read to identify the articles that will influence the way retail savings and investment products are delivered to European investors. In particular, if you read nothing else in MiFID II, read Article 24. Hidden away amongst dark pools, commodity derivatives and high frequency trading, the so-called ‘Jack Bauer’ clause has the potential to create the same degree of disruption to the European distribution landscape as the character from the TV series with the same numerical reference.

MiFID II is open to member state interpretation, and we are already seeing variations on the theme. The UK’s Retail Distribution Review (RDR) provides an extreme example, featuring a complete ban on inducements and very prescriptive competency qualifications intended to professionalise advice.

Another challenge for MiFID II was coping with a wide variety of distribution models across Europe, a situation that it struggles to reflect. It adopts the simplistic view that manufacturers make and distributors sell, and fails to recognise the concept of distribution as a service facilitating access, such as with B2B platforms. In Spain, the concept of distribution is separate from investment advice, while in Italy distribution services are classified as ‘placement’ in an agency capacity to the manufacturers. MiFID II also strays into territory covered by existing Directives, e.g. UCITS and AIFMD.

1 Speech by Sir Callum McCarthy, the then Chairman of the Financial Services Authority in the UK, at the Gleneagles Savings and Pension Industry Summit, 16 September 2006

It has therefore clearly been difficult to achieve the right compromise, but ultimately the policymaker's primary goal is to re-establish consumer confidence by ensuring appropriate safeguards are in place at point-of-sale for retail investors. In this article we shall focus only on the following aspects of MiFID II:

- What the policy makers are trying to achieve and why
- The key elements with respect to distribution included in the Directive
- What this could mean for distribution across Europe

Background – What motivated the distribution elements of MiFID II?

Consumer protection is a central theme for the Commission and MiFID II seeks to address the growing complexity of services and products offered, ensuring consumer interests are safeguarded. Much of the debate on distribution centres on 'inducements' paid by product manufacturers to distributors, motivating product push rather than client suitability. The Commission wrestled with whether this should apply across all distribution models (as is the case in the UK) or just independent advisory models, compromising with detailed obligations around transparency and disclosure in circumstances where rebates are

permitted. In the end, a complete ban was regarded as too disruptive in some markets, and considered likely to result in large numbers of retail clients being unable to access advice.

What you need to know from the MiFID II text and ESMA Consultation Paper – Key Points

To frame our discussion of consequences and the possible impact on the distribution landscape, the following elements are most relevant:

- Key principles – investment firms must:
 - Act in the best interests of clients at all times
 - Disclose the cost of advice
 - Clarify and explain the basis of advice
 - Apply a competency assessment to its advisory staff
- A ban on inducements for independent advice and discretionary management
- Prescriptive disclosure to clients of all costs, whether advised or not
- Definition of independent advice, essentially requiring an assessment of a sufficient range of different providers that are not closely linked entities
- A distinction between advised and execution-only models

Another challenge for MiFID II was coping with a wide variety of distribution models across Europe, a situation that it struggles to reflect



- Complex products (including structured UCITS and non-UCITS) only available through an advised offering
- Similar investor protection requirements should apply to investments packaged under insurance contracts but remain subject to detailed rules still to be developed

The Directive mirrors the MiFID obligation on investment firms to “act honestly, fairly and professionally [...] in the client’s best interests,” but ESMA is now proposing substantial prescription to define this further.

Such over-prescription, on top of clear and unambiguous principles, may result in a proliferation of inadvertent breaches, the stifling of innovation, and dumbed-down products, none of which is in the best interests of the consumer. Better to use sanctions as a big stick, with a few early examples, in situations where the core overarching principles are broken, than to try to micro-manage with prescription.

How will this change the distribution landscape?

Three predictions are commonly made:

Myth number 1: a significant number of Independent Financial Advisers (IFAs) will disappear from the industry

Reality: The IFAs who leave the industry are most likely the commission junkies who have gorged on a diet of rebates for years, and were more akin to salesmen or product pushers than advisers. It was this group in particular that McCarthy railed against in his speech; in his analogy, these were the captains of the ships paid based on the number of convicts loaded onto vessels at the port of departure, while the new model requires them to be paid based on the outcome at port of arrival. Often, the clients of these advisers were clueless as to precisely what they were paying for ‘advice’. MiFID II does not use the word ‘inducement’ by accident. EU Memo 14/2992² on KIDs quotes examples discovered by the Ombudsman in one member state of 12-year bonds being sold to the very elderly, and in another member state a survey suggested 50-80% of consumers were terminating long-term investments early, indicating they were not suitable in the first place. The industry was tarnished by those amongst them searching for the latest product commission offer to churn into client portfolios. New discipline around competency standards will also initially result in reduced numbers.

Frankly, the disappearance of these ‘advisers’ would be a welcome consequence of the Directive.





Myth 2: Retail clients with smaller portfolios will be unable to afford advice or be denied access to it, as IFAs will exclusively focus their efforts on mid and high net worth individuals

Reality: If such clients have used advisers in the past they will have paid for advice, but were probably unaware how much. The 'advice' was often generic and paid for largely by trail commission. Many of these clients received no ongoing advice and probably never saw their 'adviser' again. For the adviser, the real difficulty here is that they must now explain the true cost of advice and charge an explicit advisory fee. The client must decide if the cost is still justified based on the perceived value of that advice.

For portfolios below a certain threshold (probably around €75,000), it is difficult to see how the cost of advice in any model (commission or fees) could justify enhanced yields which may (or may not!) accrue. Such clients may be better off using an execution-only platform offering a guided approach to suitability and directing the client towards an appropriate panel of investment choices.

It must be recognised that giving financial advice is now a profession, no different to giving legal advice. Upskilling through competency qualifications and statutory obligations is crucial. Advice will then be channelled to where it should be: around complex, higher-value portfolios. No-one should pay for advice on which Individual Savings Account (ISA) to invest in, any more than you would pay a lawyer for advice on a parking fine.

MiFID disclosure obligations were too general, and practice varied by member State and channel. For too long, retail clients have been under the impression that advice was free, as the adviser often explained that it was paid for by commissions from the product provider; a factually correct but not very transparent disclosure. The problem therefore is not a matter of affordability but discovery, and many clients will realise the bargain has been weighted against them.

So will the MiFID II changes mean smaller retail clients will be excluded from the advised market? Empirical studies³ in the UK show there has been a marginal shift (2%) of clients from advised to non-advised following

² European Commission Memo 14/299, published on 15 April 2014, on Key Information Documents (KIDs) for packaged retail investment and insurance products, frequently asked questions

³ Financial Conduct Authority guidance consultation on Retail investment advice, published in July 2014, paragraph 2.7, referring to research involving over 4,000 respondents

RDR, but a greater shift from non-advised to advised (4%). Perhaps it is too early to tell, and the full impact of a trend amongst retail banks to exclusively focus 'advice' on higher-end clients has yet to be felt, but so far the UK is not reporting a seismic departure of clients from an advised model.

However, even under the current model where clients believe they get advice for free, only 11% of European households own a fund, and cash accounts for 40% of European household assets. Contrast that to the US, where 62% of households with an income of less than US\$100,000 own a fund but rarely pay for advice. Perhaps the lesson here is that sometimes our industry gets lost in its own rhetoric, and what the vast majority of savers with smaller portfolios really want is a simple product offering slightly better yield than a bank account. That option should be accessible to everyone, without the need to pay for advice

Myth 3: Open architecture is at risk, and we will see a retrenchment into a rebate-remunerated tied advice model, particularly by the retail bank channel

Reality: It is true that MiFID II will still permit a commission-based remuneration model, as the ban on inducements applies only to independent advice. However, the words 'tied advice' are an oxymoron — how can it be 'advice' in the context of suitability when the solution is selected from a tied panel? Banks selling tied products have a history of suitability issues, with Payment Protection Insurance in the UK perhaps being the best example.

The open architecture model emerged within the bank channel because banks realised their own in-house products generally produced inferior performance to third party funds, and they had to offer better performance. Their initial solution was to offer sub-advisory mandates to bank-branded products. Even then, client demand for choice meant those banks had to offer more than a single branded range. New B2B infrastructures emerged, facilitating easy access to an open architecture shelf with attractive economics.

It must be recognised that giving financial advice is now a profession, no different to giving legal advice

Why should this change now, just because rebates are banned? The banks can either elect to continue with an advised service, with a fee payable by their clients (presumably equivalent to the previous commission flow), or offer an execution-only option and continue to be remunerated through rebates, albeit with full and explicit disclosure to their clients.

If a retrenchment occurs it would go some way to proving why the inducement ban is necessary, as it would suggest the bank-advised open architecture model was driven more by commission than suitability. Market forces and consumer demand should determine whether such a retrenchment would be successful or not. I suspect it will prove unattractive, and new open architecture models and channels will emerge and prevail, perhaps through cross-border web-based tools able to switch rebate models depending on whether a member state has adopted a full or partial inducement ban, rather than the branch model. Consumers want and demand choice, and retail outlets will ignore this at their peril. The bank outlet will increasingly look like a direct-to-consumer (D2C) platform, which can only be a good thing for consumers.

What changes can we anticipate in the way retail clients access savings and investment products in the future?

Perhaps the best place to look is the UK, where RDR has been in place since early 2013. Some general observations emerge that may indicate how these may spread across Europe:

Platforms and channels:

- 'Platform' refers to client-facing platforms operating a D2C execution-only or advisory model, which are increasingly used by IFAs to facilitate product access for their advice solutions⁴. The D2C platforms appear to be in a good position to gather new clients, especially orphans falling out of the IFA model. The big will get bigger, as they use their buying power to negotiate lower fees ('superclean' share classes) from product providers, attracting more clients whose assets are 'influenced' or corralled into the superclean share class through a list of promoted funds. As a result, big funds able to offer superclean will just get bigger, as best-seller funds become a self-fulfilling prophecy, preordained by platform-promoted lists. Of course the key question here is whether a superclean share class is a new form of inducement used by platforms to gain volume, for which they may charge a higher platform fee to their clients
- The integrity of promoted funds lists is an issue that is likely to be scrutinised by regulators, as they are increasingly realising that the cost of a product is only one part of the equation, and the value added through performance must also be taken into account
- With fund houses eager to access asset-gathering machines – increasingly recognised as aggregators rather than distributors – a price war has emerged. This may squeeze out boutiques unable to compete purely on price but whose performance may be better than the best-sellers
- Execution-only platforms may need to reconsider their commercial model, moving towards a transaction and safekeeping fee rather than an ad-valorem fee. The cost to execute an order for €10,000 is no different to the cost to execute a €50,000 order, so why should a basis point fee apply? Similarly, how can this model continue to take trail commissions when by definition 'execution-only' implies no ongoing relationship with the client?
- The FCA in the UK has issued an excellent consultation paper⁵ seeking to encourage the industry to provide access to simple savings products for clients with straightforward needs. This should open the way for innovative new channels, offering filters to enable most people to find the right product without the channel straying into 'advice', like buying insurance from a comparison website



- IFA usage of platforms will increasingly focus on pre-constructed model portfolios aligned to risk ratings. This is driven partly by simple economics and partly by fear of liability for tailored portfolios which prove to be unsuitable
 - This concept is being taken a stage further by innovations such as Nutmeg, offering advised discretionary management of pre-packaged portfolios via a web-based service, at affordable (and transparent) prices
 - Lessons will increasingly be learned from other retail commerce sectors, especially web-based services. Features including peer group recommendations (consumers trust other consumers more than experts), unsolicited prompts or calls to action, ease of use (e.g. shopping baskets, one-click buttons) and superb customer service through a trusted and ubiquitous brand will emerge on D2C platforms once there is clarity around the boundary of the personal recommendation definition
 - Performance and brand will also become more important in filter-driven D2C execution-only channels
 - Share class proliferation will continue, bringing with it naked exposure through prospectus disclosure to the best deals offered by each fund house
 - Passive funds and low-cost ETFs will continue to gather more assets than before, as fee-based IFAs will seek to keep the cost of a client portfolio as low as possible to justify the additional adviser fees
 - Perhaps the very large fund houses – with a broad range of funds and the financial strength to build their brand – will enter the platform market with their own offering. Thousands of orphan clients remain on the share register of these funds, and could form the initial substance of such a move
 - New commercial models may emerge, such as the zero-cost share class (sometimes known as ‘distributor pays’). This new idea is yet to gain traction but essentially allows a fund house to open a new share class, made available only through selected outlets, where the distributor pays a fee directly to the fund house on a bi-lateral arrangement rather than the fund manager taking a fee from the fund
- How will the fund houses react and evolve?**
- The winners may be the larger fund houses that have the muscle to pay for aggregation via heavily discounted share classes



It must be recognised that giving financial advice is now a profession, no different to giving legal advice

4 It is acknowledged that other member states may not impose the blanket ban on inducements the UK has adopted, and that execution-only platforms may be permitted to continue to receive rebates. This may result in different outcomes to those described in the UK

5 Financial Conduct Authority guidance consultation on Retail investment advice, published in July 2014



Policymakers want to create an environment where consumer trust and confidence can be restored

Conclusions

MiFID II is a complicated Directive covering a huge range of subjects, each substantial in their own right. Coupled with the ESMA consultation documents, reading the two together reminds me of Churchill's *"riddle, wrapped up in a mystery inside an enigma"*. There is clearly some way to go before the ESMA Level Two text is finalised, and I have rarely seen the responses to ESMA consultation questions begin so often with the phrase *"no, we do not agree with ESMA"*.

However, policymakers want to create an environment where consumer trust and confidence can be restored. The industry now needs to deliver on choice and integrity of channels and products to encourage the transfer of the 40% of European household wealth still held in cash into more suitable savings and investment products. If the European ratio of household wealth held in funds reached US levels, some €3.9 trillion of new assets could be gathered into funds. Forget China, Europe is where the distribution and asset gathering opportunity is!

To the point:

- MiFID II is a complex Directive covering a huge range of topics, from dark pools to commodity derivatives and high frequency trading. This article breaks it down to the elements designed to further enhance consumer protection at point-of-sale for retail savings and investment products
- It started with RDR in the UK, and now MiFID II enshrines the same principles around the removal of the inevitable conflict between commission-led product supply and client suitability
- For too long, European retail clients have believed that advice was free, explained through minimal disclosures as paid for by product commissions. This is factually correct but hardly transparent
- MiFID II seeks to professionalise advice and harmonise its definition across Europe. The industry needs to adapt by commercialising the new reality
- Three predictions are often made about the consequences of a shift from commission to fees:
 - There will be significantly fewer independent advisers
 - An 'advice gap' will emerge for clients with modest portfolios
 - The bank-dominated open architecture models will retrench into rebate-remunerated tied advice
- All three of these predictions are challenged as myths, with an alternative reality proposed
- Changes in the distribution landscape will occur:
 - Large D2C platforms will become bigger
 - Simplified advice will move online, encouraged by regulator-led clarity on where the boundary of personal recommendation lies
 - Independent advisers will increasingly use pre-packaged model portfolios
 - New commercial models will emerge
- Across Europe, if the industry delivers on choice and integrity of channels and products and this results in the same ratio of household wealth held in funds as in the US, nearly €4 trillion in additional assets could be gathered into funds. Forget China, Europe is where the opportunity lies

Third-party Management Companies

A new governance model?

William Jones
Founder and Senior Partner
ManagementPlus Group

The third-party management company is a familiar concept originating with UCITS. It has taken its next evolutionary step with AIFMD. The traditional model has to evolve from focusing on regulatory compliance to emphasising asset class and actual operations.

Investors have been focusing on the governance of investment funds ever since the unpleasant surprises experienced as a result of the global financial crisis of 2008/09. These included severe write downs in net asset values of funds and securities held by them, delayed payment of redemption proceeds, gating of funds, suspension of redemption rights, counterparty failure and, more extremely, insolvency of the funds themselves. Many investors, institutional or otherwise, felt that the service providers of funds which found themselves in trouble during the crisis, in particular investment managers and directors—who were tasked

with managing and overseeing the funds—could have done more to support the funds in managing the crisis. Some investors and many prominent political and regulatory figures have even stated that there was a systemic failure of the fund governance model internationally. While such views may or may not be justified in specific cases, and they conveniently ignore how banks, investors, politicians and regulators contributed to the crisis and its handling, there is some degree of truth in the view that those charged with the governance of funds could have done better.





Various countries have responded in different ways to the aftermath of the crisis with a view to preventing a Global Financial Crisis, Part II. Most countries adopted new legislation aiming to regulate all aspects of financial markets, including the activities of investment managers, fund directors and other service providers. Others chose to follow the route of suggesting that codes of conduct be applied either on a mandatory or voluntary basis. A few decided to regulate further the activities of the funds themselves. Many ended up regulating the investment fund industry indirectly through banking, derivatives, tax and other specific regulatory initiatives. Investors have effectively overlaid the funds industry with indirect regulation in the form of due diligence teams that proliferated worldwide. One can argue about the merit and risk/reward calculus of these various regulatory and private initiatives, but ultimately it is clear that the industry has developed into a much more complex environment.

It is against this backdrop that the role of the third-party management company is evolving.

The concept of the third-party management company has its origins in the UCITS world—every UCITS fund (other than a self-managed one) requires a ‘management company’ to manage the fund (generally referred to in the industry as a ‘ManCo’). The investment manager, as sponsor of the fund (i.e. an institutional asset manager, investor, bank or hedge fund manager) can either establish and operate its own ManCo or call on a third-party ManCo service provider. UCITS rules require that the ManCo legally manages the fund, but generally the ManCo delegates portfolio management and risk management to the sponsor’s chosen investment manager, and administration and custody activities to an external administrator and custodian. The ManCo may also delegate distribution to a global distributor or sub-distribution network.

Given the extent of outsourcing in the UCITS model, the traditional UCITS ManCo focuses more on monitoring the delegated operations of the fund and ensuring compliance with UCITS regulations by the various service providers, rather than on running the fund itself on a day-to-day basis. It should be noted that even though the ManCo may delegate various fund-related functions to other parties, it retains legal responsibility for the proper discharge of those functions. So while generally the traditional UCITS ManCo remains legally liable for all fund activities, it rarely 'does' anything when it comes to actual operations—rather most UCITS ManCo service providers view their roles as being driven by regulation and compliance. While this model has been highly successful in the UCITS sphere, it will be trickier to implement in the more complex world of alternative investment funds.

The combination of recent regulatory developments should result in a shift in the traditional UCITS ManCo 'compliance' model:

- Luxembourg CSSF circular 12-546 (the 'substance circular') issued in autumn 2012 which generally requires UCITS ManCos to have more 'substances on the ground in Luxembourg
- The EU's Alternative Investment Fund Managers Directive came into effect between July 2013 and July 2014, after five years of legislative and regulatory wrangling, and AIFMD II is already in preparation
- National and international tax regulation, jurisprudence and discussions on proposed regulation (such as BEPS) have evolved to require greater substance on the ground for entities wishing to avail themselves of tax treaty benefits

The aggregate effect of these regulations is to require third-party ManCos to have more substance, meaning that they cannot be 'letter-box' companies or have a light operational base.

It is against this backdrop that the role of the third-party management company is evolving

"AIFMD requires the demonstration, initially and on an on-going basis, of significant substance in companies and their senior management that seek to be approved as AIFMs, both for portfolio and risk management. In the traditional cross-border fund centres such as Luxembourg, senior people with the necessary experience, especially in private equity and real estate, but also in hedge and traditional investment strategies, are increasingly difficult to find" – Keith Burman, Partner, ManagementPlus Group.

It is somewhat unclear at this stage what this means in practice. To be fair to regulators, it is important to recognise that most of the regulations requiring substance have been politically mandated and typically poorly drafted. Regulators are operating just as blindly as the affected sectors of the funds industry, although everyone's experience with AIFMD at the European level, the substance circular in Luxembourg and other such regulations increases every day. However, it is clear that the traditional UCITS ManCo model will not work for UCITS anymore. AIFMD charges the ManCo with control and management of the fund at a much more operational level than the early UCITS legislation ever foresaw. In this sense we can see a convergence between the UCITS and AIFMD ManCo models. While this may be considered a detriment and an unnecessary increase in costs by many investment fund managers and even some investors, it does raise an interesting possibility—that of a ManCo that can provide operational value-added services to a fund.



The traditional 'compliance' third-party ManCos are generally populated by former compliance officers, auditors, administrators, etc.—in other words, by individuals who do not have actual experience working with an investment manager. While this may have worked in the past, it is no longer a viable option given the new regulatory framework. If the third-party ManCo is to insert itself into the fund structure as an effective gatekeeper (for investors but also for all other stakeholders of the fund), its management and personnel must have:

- Relevant background and experience—to discuss and, if necessary, to handle portfolio and risk management issues, it is essential that the third-party ManCo has staff with specific asset class knowledge (i.e. equities, fixed income, commodities, FX, hedge, private equity, real estate, infrastructure), if nothing else to be able to communicate with the investment manager and the other service providers using the same technical and industry language
- Practical operational experience—to be an added-value proposition to the investment manager, in addition to the regulatory and compliance functions, a third-party ManCo should also be able to provide actual operational support to the investment manager, which can have many cost and tax advantages depending on the structure
- A policy of engagement with the investment manager/sponsor and all other stakeholders of the fund—communication between the ManCo and the service providers should not be limited to quarterly board meetings or monthly service provider meetings, but should be continuous and take place as often as necessary
- A problem-solving mindset—the ManCo's staff should have the ability to foresee problems before they happen, handle them efficiently and effectively when they happen, and exercise leadership to focus the fund service provider team on developing and implementing appropriate solutions
- An understanding of the fund eco-system and team orientation—ultimately the ManCo has to lead the team of service providers of the fund to reduce the odds of failure; while the risk of failure cannot be eliminated, its occurrence and impact can be minimised by the ManCo if it has the qualities listed above



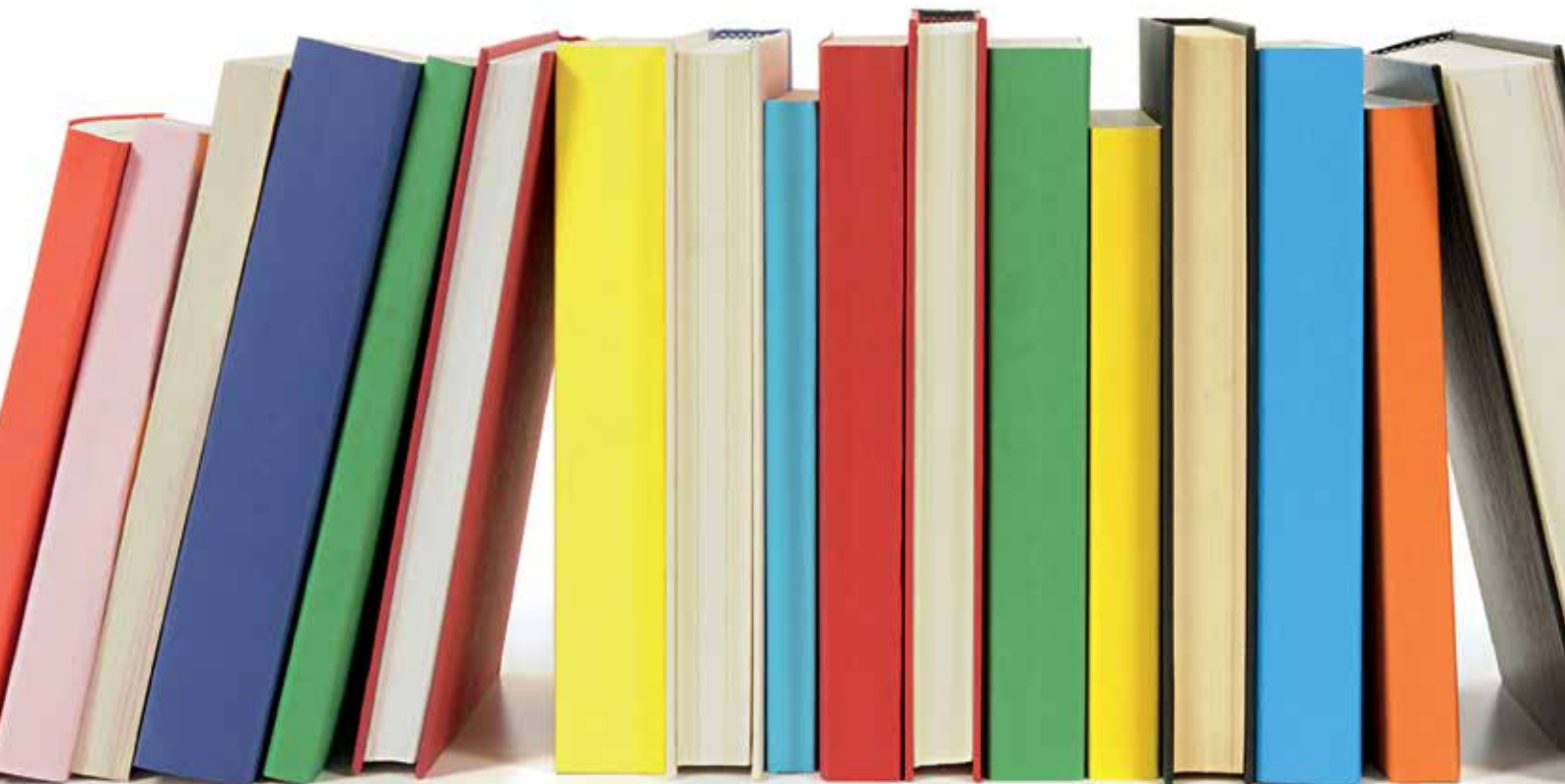
To be fair to regulators, it is important to recognise that most of the regulations requiring substance have been politically mandated and typically poorly drafted

Of course all of these value-added qualities have to be delivered over and above the traditional regulatory and compliance requirements for a third-party ManCo, whether under UCITS or AIFMD:

“Third-party management companies could be the next iteration of the front, middle and back office outsourcing concept. The function of operational third-party management companies is not to replace the investment manager as sponsor or the administrator as middle or back office service provider, but to work with them to strengthen the fund’s operating model as an independent value-added proposition.” states Antonio Thomas, Partner, ManagementPlus Group

To the point:

- While the third-party ManCo model is generally a European concept, it does not have to be limited to the geographical borders of Europe
- One can envisage interesting applications of this model to funds established in the Cayman Islands and other offshore jurisdictions
- The third-party ManCo should be viewed as another tool for fund governance, but a better one, if it provides operational added value to the investment manager/ sponsor and ultimately greater comfort to investors and regulators. While the ‘new’ operational third-party ManCos may not prevent the next crisis, they should go a long way to ensure that a fund operates in accordance with applicable regulations and the disclosures provided to its investors



CSSF Circular 14/587 on UCITS Depositaries In a nutshell

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The CSSF recently published a Circular inviting Luxembourg UCITS and their depositaries to anticipate the so-called directive 'UCITS V' via a substantial alignment and harmonization with the common elements of the UCITS and AIFMD depositary regimes.

The Circular provides that its recipients must comply with its provisions by 31 December 2015 at the latest, i.e. less than three months ahead of UCITS V which is to be implemented by 18 March 2016.

A closer scrutiny at the rules contained in the Circular further shows that what might appear to be an unusual 'gold-plating' move by Luxembourg should in fact prove to be for many operators a confirmation of their current best-market practice.

For both practical and cost-effective reasons, UCITS depositaries might consider implementing the terms of the Circular and of UCITS V at the same time, and thus be (almost) fully UCITS V compliant on depositary aspects by 1 January 2016.

The Circular draws particular attention to certain aspects deemed essential in relation to the depositary function

A. The Circular in general

- 1. Circular 14/587**—On 11 July 2014, the Luxembourg Commission for the Supervision of the Financial Sector (CSSF) published a new circular numbered 14/587 and entitled "*Provisions applicable to credit institutions acting as UCITS depositary subject to Part I of the law of the 17 December 2010 relating to undertakings for collective investment and to all UCITS, where appropriate, represented by their management company*" (the 'Circular' and the 'UCI Law', respectively).¹
- 2. Recipients**—The Circular targets and applies (A) to Luxembourg credit institutions, including the Luxembourg branches of EEA credit institutions, acting as depositaries of Luxembourg UCITS within

¹ The full text of the Circular in French is accessible on the CSSF website and an English translation will soon be published on the EHP website

the meaning of articles 17 and 33 of the UCI Law, as well as (B) to these Luxembourg UCITS themselves, including, as the case may be, UCITS management companies². Other Luxembourg funds and SICARs (including their management companies or managers, as the case may be) and their depositaries remain governed either by the regime instituted by the Alternative Investment Fund Managers Directive (AIFMD) or that resulting from the basic Luxembourg legal provisions applicable to depositaries, as implemented by Chapter E of IML Circular 91/75.

3. Purpose and content—The purpose of the Circular is to clarify the depositary regime provided for by the UCI Law by defining new organisational arrangements that must be put in place by the Circular’s recipients in terms of the UCITS depositary function’s duties, obligations and rights. The Circular draws particular attention to certain aspects deemed essential in relation to the depositary function. Among these elements, the Circular sets out rules relating, inter alia, to the segregation of UCITS assets throughout the delegation chain, the initial and ongoing due diligence of the entities intervening in the custody chain of the UCITS assets, the identification, resolution and avoidance of conflicts of interest, and the adequate booking and monitoring of cash flows. The Circular also describes organisational rules and rules of conduct with which credit institutions should comply in order to be approved as UCITS depositaries. A number of the rules set out in the Circular are discussed in further detail in Chapter 2 of this memorandum.

4. AIFMD and UCITS V, alignment and anticipation—*“The Circular establishes, as far as practicable³, an alignment and anticipates a harmonisation of the UCITS and AIF’s depositary regimes with respect to their common elements, as implemented by the so-called directive ‘UCITS V’^{4,5}. This is true. The Circular, however, falls short of implementing some of the fundamental changes of UCITS V⁶, the first of which being the strict liability regime for loss of assets held in custody⁷, and that—to a large extent⁸ and as already stated under paragraph 3 of this memorandum—the Circular only clarifies via more detailed and prescriptive guidelines most of the key rules contained and drafted in a principled-based format in IML Circular 91/75 when defining the missions of the depositary. As a matter of fact, the Circular⁹ remains in line with the key principle of the parliamentary works (confirmed by IML Circular 91/75) whereby the mission of the depositary is a mission of surveillance and not of custody. However, this does not prevent the Circular from distinguishing certain organisational arrangements to be implemented depending on whether assets are held in custody or not.*

The Circular also describes organisational rules and rules of conduct with which credit institutions should comply in order to be approved as UCITS depositaries

² In this memorandum, reference to ‘UCITS’ must be understood, where applicable, as including a reference to this UCITS’ management company

³ The CSSF might have more rightly provided “as far as the current UCITS legal framework allows it”

⁴ See the third paragraph of the Circular’s introduction

⁵ ‘UCITS V’ designates the UCITS Directive 2009/65/EC as last amended by Directive 2014/91/EU of 23 July 2014. This latter Directive was published in the OJEU of 28 August 2014, i.e. post date of publication of the Circular

⁶ Precisely because the current UCITS legal framework does not allow it

⁷ As a matter of fact, the Circular expressly provides that “Regarding the liability regime applicable to UCITS depositaries, because this aspect is not covered by the Circular, one should refer to the legal provisions applicable under the UCI Law”; to which we should probably add “as implemented by point IV, of Chapter E of the IML Circular 91/75” (even though the latter is expressly repealed by the Circular as from 1 January 2016 in relation to UCITS depositaries)

⁸ The Circular also covers points (such as the cash monitoring obligations) that were not specifically addressed in Chapter E of the IML Circular 91/75

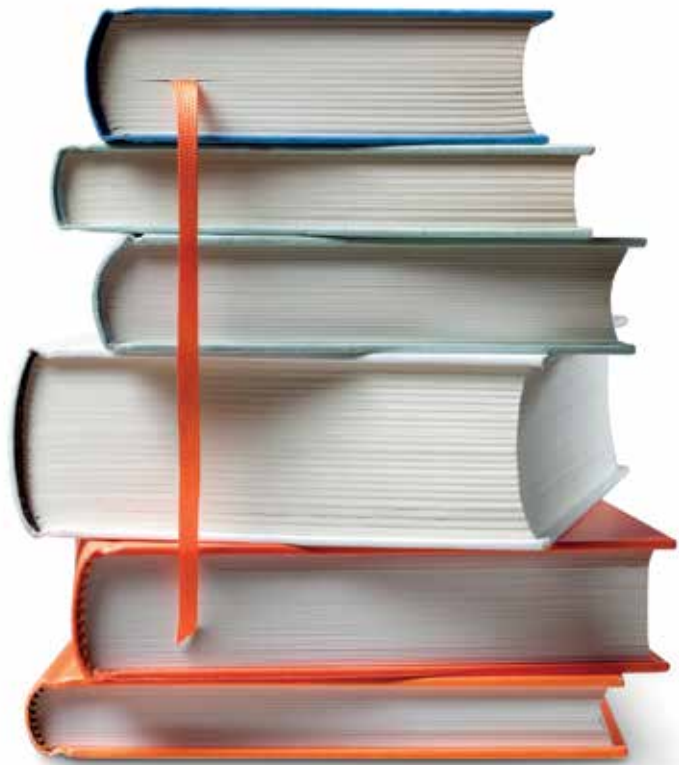
⁹ See Point 46 of the Circular

5. **Timing**—The Circular provides that its recipients must comply with its provisions by 31 December 2015 at the latest, subject to other transitional provisions that might become applicable once UCITS V is implemented. This means quite a long (and welcome) transitory period of almost 18 months. It is interesting to note that, without prejudice to its own transitory regime, the UCITS V framework will come into force on 18 March 2016.

B. Certain elements of the Circular in particular

6. **Approbation**—Luxembourg law does not provide for a specific ‘depository licence’. It does, however, require the depository to be approved in relation to any appointment by a UCITS¹⁰. The Circular¹¹ now conveniently provides detailed rules regarding the file to be submitted, the procedures to be implemented and the conditions to be fulfilled for a depository to be granted such approval. In this context, due consideration must be given to the characteristics of each relevant UCITS, meaning that the same depository may be approved in relation to certain types of UCITS, but not in relation to other types of UCITS. A non-exhaustive list of the information to be submitted to the CSSF (and to be kept up-to-date) is provided in Appendix 2 of the Circular. The Circular contains favourable transitory provisions for existing UCITS depositories¹².

7. **Depository agreement**¹³—The CSSF has always requested that the involvement of a depository for a given UCITS be drawn up in a written agreement. The Circular confirms this requirement, but now lists the elements that this agreement must cover and defines certain key principles governing it. These elements and principles¹⁴ are contained in Chapter 3 of Part II and in Appendix 1 of the Circular. Appendix 1 of the Circular is closely inspired by article 83.1 of AIFM Regulation 231/2013.



8. **Depository/UCITS relationship**—Regarding the relationship between the depository and its UCITS clients, and in addition to the foregoing requirements applicable to the depository agreement, the Circular¹⁵ requires that each of its recipients establishes and implements an appropriate **escalation procedure** for situations where an anomaly is detected, including possible notification of the CSSF, and lists certain rules and conditions with which these procedures must comply. The Circular¹⁶ also provides for a (reciprocal) **obligation of information** between the depository and its UCITS clients.

¹⁰ Article 129(2) of the UCI Act

¹¹ Chapter 2 of Part II of the Circular

¹² Point 7 of the Circular

¹³ The Circular refers to the “depository designation agreement”

¹⁴ These elements and principles come in addition to those referred to in Chapter V of CSSF Regulation N° 10-04 in relation to a UCITS whose management company is not based in Luxembourg

¹⁵ See Chapter 4 of Part II and Points 186 of the Circular

¹⁶ See Parts IX and X of the Circular



9. Conflicts of interest—The Circular dedicates a specific chapter¹⁷ to the rules and procedures with which the depositary must comply in relation to conflicts of interest. In this context, the Circular specifies, inter alia, that:

- No delegation of the core investment management function can be made to the depositary or to an entity involved in the custody chain
- The delegation of the core investment management function, however, is not restricted to an entity linked to the depositary by common management or control
- Although the risk management function cannot be delegated to the depositary, the latter can be entrusted with certain duties linked to the aforementioned risk management function

- Subject to certain conditions specified in the Circular, the depositary may act vis-à-vis its UCITS client in different capacities (administration and transfer agent, e.g.), which are non-exhaustively listed in Point 32 of the Circular
- Subject to certain conditions relating inter alia to conflicts of interest, the depositary may hold equity interest in its UCITS client's management company
- No one employed by the depositary may act as conducting officer of a UCITS

10. Governance of the depositary functions—The Circular¹⁸ requests that the depositary establishes and implements written procedures and, where appropriate, enters into specific appropriate contractual arrangements with third parties in relation to its functions as depositary.

No one employed by the depositary may act as conducting officer of a UCITS

¹⁷ Chapter 1 of Part III of the Circular

¹⁸ Chapter 2 of Part III of the Circular

These procedures and contractual arrangements cover, inter alia, the types of mandates (based on the characteristics of the UCITS) the depositary considers itself able to service, the depositary's internal process for accepting new designations by a specific UCITS, the relationships with third parties (such as administrative agents) with whom the depositary must liaise when performing its functions, and more generally, all aspects linked to the function of the depositary. The Circular also specifically requires the intervention of the depositary's internal audit and control department to ensure that all such procedures and contractual arrangements are drawn up, updated and implemented.

11. Organisational requirements—Almost half of the Circular, namely Part IV entitled "*Organisational arrangements to be implemented in relation to the UCITS assets*" and Part V entitled "*Booking and adequate monitoring of cash (flows)*", is dedicated to the depositary's organisational requirements. A detailed examination of these requirements clearly exceeds the scope of this memorandum. In the following bullet points, we propose instead to express a few general comments to highlight a few points we deem of particular interest.

- The common denominator of these organisational requirements is that, in one way or another and either directly or indirectly, they concur that the depositary should at all times fulfil its main mission of having an overall view of how the UCITS' assets are invested and where they are located, whilst having sufficient comfort of the UCITS' ownership rights over these assets.

- The majority of these organisational requirements are closely inspired by the requirements detailed in articles 21.7 and 21.8 of the AIFMD, and in their implementing articles 85 to 91 of AIFM Regulation 213/2013.
- The Circular makes a distinction between the requirements applicable to the assets held in custody by the depositary¹⁹, the assets held in custody by third party custodians/sub-custodians and by any party further down the custody chain²⁰ and to the assets not held in custody²¹. An additional distinction is made between the cash and non-cash assets, the former being subject to the specific booking and monitoring requirements provided for in Part V.
- The Circular requires the **segregation** of the UCITS' assets both at internal²² and at third-party levels^{23,24}. For the most part, the Circular aligns itself with the segregation rules and principles contained in articles 21.8 and 21.11 of the AIFMD and in articles 89, 98 and 99 of the AIFM Regulation 213/2013. In the context of the segregation at third-party level, the Circular refers to the somewhat new concept of "*assets [of the depositary's clients] being subject to collective management*"²⁵. We understand a depositary would then be required to open and maintain a minimum of three accounts with its correspondents: (i) one for these assets subject to collective management (presumably the assets belonging to all the depositary's clients qualifying as UCIs or SICARs, whether AIFs, UCITS or not), (ii) one for the assets of its other clients and (iii) one for its own assets.

¹⁹ Chapter 1 of Part IV of the Circular

²⁰ Chapters 2 and 3 of Part IV of the Circular

²¹ Chapter 4 of Part IV of the Circular

²² See point 55 of the Circular

²³ See points 57-60 and 63 of the Circular

²⁴ The Circular also addresses or reiterates its segregation requirements in the context of the due diligence process to be implemented by the depositary (points 74-75 of the Circular), of the designation of a prime broker (point 99 of the Circular), of the concentration of custody with a limited number of third parties, or even with a single third party (point 104 of the Circular), of cash accounts (point 118 of the Circular) and of the minimum content of the depositary agreement (Annex 1 (o) of the Circular)

²⁵ Point 74.e) of the Circular refers to a 'more granular' segregation at third party level as it refers to 'assets of the depositary's UCITS clients'. This is a clerical error in the drafting of the Circular

- Without prejudice to the foregoing, the Circular requires that initial and on-going **due diligence** be conducted in relation to any entity involved in the custody chain of, or the intermediation with, the UCITS assets, and, if need be, that back-up plans be made operational and relevant measures be taken when any of these entities fails to comply with its obligations. The Circular provides quite detailed and prescriptive (non-exhaustive) rules and principles in this regard, some of which are also largely inspired by the AIFMD provisions. These rules and principles distinguish between the due diligence to be performed in relation to assets held in custody²⁶ or not²⁷. The Circular reserves specific

arrangements. Vis-à-vis entities intervening in the 'second degree' of the custody chain, this right of information and instruction may be indirect³⁰.

- The Circular contains specific, sometimes quite detailed and prescriptive, organisational requirements in relation to:
 - **Collateral** arrangements³¹
 - Investments made by the UCITS (i) in **derivative** financial instruments³² or (ii) in **other UCIs**³³
 - The designation of a **prime broker**³⁴
 - **Concentration of custody** with a limited number of third parties, or even with a single third party³⁵
- The Circular³⁶ provides for a general obligation to establish, update and implement **reconciliation** procedures covering all the assets of the UCITS and related transactions, and clarifying the measures to be taken by the depositary in case a discrepancy is identified.
- In relation to **cash assets**, the Circular³⁷ aligns itself with the cash monitoring obligations set forth in article 21.7 of the AIFMD and its implementing articles 85 to 87 of AIFM Regulation 213/2013. It hence anticipates UCITS V which, in that respect, mirrors³⁸ the aforementioned AIFMD provisions. In this context, the depositary is required to ensure that UCITS cash accounts are opened only with entities meeting the requirements of article 21.7 of the AIFMD (a 'qualified entity').

The Circular confirms the principle whereby any such oversight or control can be performed ex post

developments for the due diligence to be performed in relation to the investments made by the UCITS in other UCIs²⁸.

- The Circular reiterates, in a more detailed and prescriptive format²⁹, the obligation contained in IML Circular 91/75 whereby the depositary must ensure a direct **right of information and instruction** in relation to the UCITS' assets, including in the context of collateral

²⁶ Sub-chapter 5.1 of Part IV of the Circular

²⁷ Sub-chapter 5.2 of Part IV of the Circular

²⁸ Sub-chapter 5.3 of Part IV of the Circular

²⁹ Chapter 6 of Part IV of the Circular

³⁰ See point 86 of the Circular

³¹ Sub-chapter 7.1 of Part IV of the Circular

³² Sub-chapter 7.2 of Part IV of the Circular

³³ Sub-chapter 7.5 of Part IV of the Circular

³⁴ Sub-chapter 7.3 of Part IV of the Circular

³⁵ Sub-chapter 7.4 of Part IV of the Circular. To be read in conjunction with Chapter 6 of Part VI of the Circular

³⁶ Chapter 8 of Part IV of the Circular

³⁷ Chapter 1 and 2 of Part V of the Circular

³⁸ It is to be noted, however, that if UCITS V (see new article 22.4) indirectly authorises cash accounts to be opened with a bank authorised in a third country, it does not seem to authorise (as the AIFMD does) cash accounts to be opened with "another entity of the same nature, in the relevant market where cash accounts are required provided that such entity is subject to effective prudential regulation and supervision which have the same effect as Union law and are effectively enforced"

Chapter 3 of Part V of the Circular deals with the obligations of the UCITS and the depositary in relation to money resulting from subscriptions (and, as a matter of fact, redemptions). In this context, point 127 of the Circular specifically provides that 'collection accounts' (which may in substance be defined as the accounts through which transit monies are exchanged between the UCITS and the investors) must also be opened with qualified entities.

12. Specific duties of the depositary—Chapter VI of the Circular is dedicated to the specific duties of the depositary and is split into two chapters:

- Chapter 1 deals with the depositary's obligations regarding the day-to-day administration of UCITS assets. It does not deviate substantially from what was already set out in IML Circular 91/75 in this regard. The Circular does, however, recommend that these obligations be extended to corporate UCITS.
- Chapter 2 deals with the specific oversight duties of the depositary and, for the most part, aligns itself with article 21.9 of the AIFMD and its implementing articles 92 to 97 of AIFM Regulation 213/2013. In this context, the Circular confirms the principle whereby any such oversight or control can be performed ex post. As in Chapter 1, the Circular recommends that the specific oversight duties actually implemented in relation to corporate UCITS be aligned with all those imposed in relation to contractual UCITS.

13. Delegation—It has always been agreed that, subject to a few conditions and limitations, the depositary can delegate part of its duties and mission to third parties. The merit of Part VII of the Circular³⁹ is to reiterate this principle and to provide a more comprehensive set of rules applicable to such delegation. In part VII, the Circular:

- Provides the general rules⁴⁰ and limitations⁴¹ applicable to any delegation by the depositary
- Addresses the specific rules applicable to delegation within the depositary group⁴², to the IT outsourcing⁴³ and the concentration of custody with a limited number of third parties, or even with a single third party⁴⁴

- Confirms the possibility for sub-delegation under the condition that delegation rules are applied by analogy to the parties concerned⁴⁵

C. What to do next and when?

14. Introduction—The Circular undoubtedly requires action to be taken. These actions are first and foremost to be taken by depositaries. It would not be well-advised to unduly minimise the workload required for the Circular's recipients to comply with the new framework. However, in our opinion and as indicated in paragraph 4 above, it remains that the Circular does not introduce rules that are so fundamental as to imply significant changes and hinder implementation. It is also likely that the majority of depositaries are already compliant with most of the required changes. First of all, this is because most UCITS depositaries are also depositaries of AIFs managed by authorised AIFMs and therefore comply with the AIFMD requirements (including in relation to their network of correspondents). Secondly, this is because a number of rules contained in the Circular reflect current Luxembourg best-market practice. In the following paragraphs, we nevertheless suggest a (non-exhaustive) list of actions to consider, as well as to anticipate the implementation of the UCITS V regime.





15. Some suggested action to be taken—Recipients of the Circular are recommended to take advantage of the coming (more than one-year) period to perform the following action (non-exhaustive list):

(a) Screening by the depositary of its internal governance and organisation and, where required, filling in any identified shortfalls, particularly regarding:

- The conditions for approval as a UCITS depositary and updating the CSSF (as of 1 January 2016) in relation to the various elements and information listed in Appendix 2 of the Circular
- The capacity to handle new mandates and the process for accepting such new mandates
- The required functional and hierarchical separation of functions, for instance when the depositary is also responsible for performing administration functions or risk management duties for its UCITS clients

(b) Regarding its relationship with its UCITS clients, the depositary will pay particular attention to:

- The depositary agreement, as the latter shall certainly be brought in line with the requirements referred to in paragraph 7 of this memorandum
- The escalation procedures to be established and documented as per the rules briefly described in paragraph 8 of this memorandum
- Its information obligations as per Part VIII of the Circular

(c) Screening by the depositary of the network of sub-custodians and third-party custodians regarding:

- The due diligence already implemented. This due diligence should be expanded if need be

39 To be read in conjunction with certain developments contained in Parts IV and VI of the Circular

40 Chapter 1 of Part VII of the Circular

41 Chapter 4 of Part VII of the Circular

42 Chapter 2 of Part VII of the Circular

43 Chapter 3 of Part VII of the Circular

44 Chapter 6 of Part VII of the Circular

45 Chapter 5 of Part VII of the Circular

- The content of the agreements entered into with these entities
- Conflicts of interest (e.g. delegation of the investment management function)
- Segregation of assets

(d) Screening by the depositary of all of the UCITS' cash correspondents (including 'collection account' holders):

- To verify their eligibility
- To ensure that the reconciliations and flows of information necessary to implement its cash monitoring functions are duly organised and implemented

(e) In addition to what is provided for under (c) and (d) above, screening the relationships with all intervening third parties (including prime brokers, collateral agents and collateral managers, etc.) and to address any shortfalls identified in terms of the Circular's specific requirements with each of these parties including, where applicable, the delegation requirements.

(f) The UCITS will pay particular attention to the following points:

- The depositary agreement (see paragraph (b) above)
- The escalation procedures with the depositary (see paragraph (b) above)
- The depositary's information obligation as per Part VIII of the Circular
- The cash accounts opened or to be opened (see paragraph (d) above)

16. UCITS V directly?—The period (before being somewhat overhauled by UCITS V and its implementing detailed provisions) appears to be less than three months. In order to avoid the extra costs and time that a 'two-step upgrade' of systems, organisation, contractual documentation and procedures, etc. would entail, UCITS depositaries might consider 'skipping' the Circular phase and ensure fully UCITS V compliance by 1 January 2016, therefore in advance of UCITS V's

compulsory implementation date (i.e., 18 March 2016). If depositaries were to choose this option, they could postpone, to the latest possible date (via appropriate transitory provisions inserted in the depositary agreement), the implementation of the most stringent UCITS V rules such as the strict liability regime applicable to the loss of assets held in custody. The main merit of the Circular might then well be to encourage depositaries to adopt a smooth transition to UCITS V, whilst gradually avoiding any practical issues that would only be revealed upon actual implementation of a new regime, and thus ultimately keep Luxembourg ahead of the EU pack.

To the point:

- The CSSF recently published a Circular inviting Luxembourg UCITS and their depositaries to anticipate the so-called directive 'UCITS V' via a substantial alignment and harmonisation with the common elements of the UCITS and AIFMD depositary regimes
- The Circular provides that its recipients must comply with its provisions by 31 December 2015 at the latest, i.e. less than three months ahead of UCITS V which is to be implemented by 18 March 2016
- A closer scrutiny at the rules contained in the Circular further shows that what might appear to be an unusual 'gold-plating' move by Luxembourg should in fact prove to be for many operators a confirmation of their current best-market practice
- For both practical and cost-effective reasons, UCITS depositaries might consider implementing the terms of the Circular and of UCITS V at the same time, and thus be (almost) fully UCITS V compliant on depositary aspects by 1 January 2016

The transparency challenge in the distribution chain

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The fund industry is confronted with calls for transparency in the distribution chain for both compliance and commercial reasons. However, there is a clash between the distribution intermediaries' requirement to bundle positions and transactions to ensure efficiency in the custody chain and the fund's need for transparency to monitor distribution and screen investors.

The financial industry is continuously striving to process transactions in a faster and more efficient way. In this spirit, fund distributors resort to bundling positions and transactions before sending them downstream. However, a new focus on disclosing fund investors puts the practice of transaction aggregation and position bundling into question.

The need for transparency

Fund promoters require a clear overview of their investors' or distributors' positions for several reasons. This transparency is used for processing trailer fees as reconciling the distributors' positions claiming payments and the actual positions maintained in the register often remains unnecessarily complex. It is also needed for commercial reasons as fund promoters need to know where the funds are bought and held to measure the success of their sales strategies per region, segment or existing relationship. In addition, fund promoters want to ensure they are dealing with trusted distributors, ideally on the basis of a distribution agreement. Recent regulatory developments and compliance cases act as a further incentive to increase transparency. Regulators are aiming to increase the accountability of funds and promoters for the quality of the investors

they accept into the funds in accordance with the 'know your customer' principle and to prevent money laundering or the financing of any criminal activities. This investor screening not only prevents such criminal activities, but is also used to ensure investors are qualified to invest in the fund as per the terms of the regulation or the fund's rules and that they are informed about the level of risk they are taking.

The custody chain

In Europe, fund distribution is mainly carried out by banks in the local markets. These banks may use a local specialist intermediary to support them with this asset class, which in turn can use an international infrastructure to access the funds. This chain of local market participants has the advantage that the fund promoters can benefit from the banks' knowledge of local rules to protect them and the funds. The same logic applies in countries where independent financial advisors distribute the funds and increasingly use local or international fund platforms to support their trade and post-trade activities.



Such holding chains are obviously in the interest of the investors as the banks or platforms effectively create a trading channel which provides them with a single point of access to a broad range of transfer agents and the entire European and international domiciled fund universe. This in turn enables the aggregation of purchasing power across domiciles.

To maintain efficiency and streamline processing, most fund market intermediaries will centralise custody and aggregate orders they receive upstream to move them downstream. Omnibus accounting and aggregate trading remove the need to open thousands of accounts, reduce transaction volumes and simplify reconciliations. Similar to other fungible asset classes, such practices in the fund industry also substantially improve the overall efficiency and liquidity of the market.

The transparency dilemma

Some market participants are concerned that there will be a trade-off between efficiency and transparency and that the efficiency gains achieved by the industry in the custody chain will be sacrificed as bundling is seen as opaque.

However, the industry is not simply facing two camps with the distribution intermediaries that need efficiency and simplicity—and will inevitably generate barriers to transparency—on the one side, and the funds and their promoters requiring transparency on the other side. The dilemma is more subtle than that.

It is important to note that regulatory authorities are not only pushing in one direction but are also part of this dilemma. While the regulatory focus has recently been on 'know your investors' as indicated above, regulators nevertheless also want to encourage efficiency, transaction cost reductions for investors and overall safety in the processing chains. Initiatives such as the dematerialisation law in Luxembourg or TARGET 2 - Securities at the European level inevitably also affect the investment fund industry.

Moreover, despite the fact that fund promoters welcome transparency, they are aware of its limits and benefit from the administrative support of intermediaries. Local agents remove the need to maintain countless accounts and to check investors' names under the local rules of the distribution countries in multiple languages or even different alphabets.

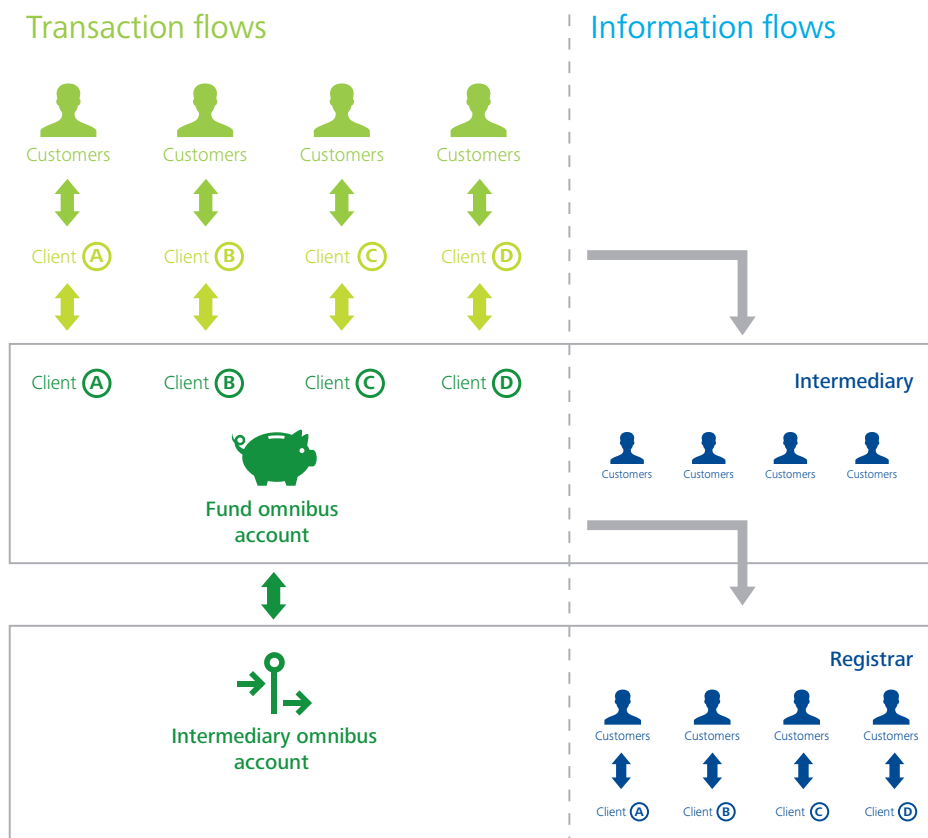
The solution

Unfortunately, there is no magic solution to the dilemma. The proposal pushed by some is full segregation. Even if the fund units have all the required characteristics to be fungible, accounts would be multiplied to provide transparency and individual segregation on fund registers. This actually puts reporting of information in the middle of the transaction process where it does not need to be.

The solution preferred by most is to maintain the custody chains and the omnibus accounting and, at the same time, supplement these operational flows with reporting tools that will provide the additional information needed by the funds and their promoters.

Since the intermediaries in the distribution chain are the ones who bundle the orders and the settlements, they are in a unique position to unbundle them again and provide the information. This unbundling can be performed at both transaction and position level. At transaction level, orders or settlements are tagged with information that will instantly enable the fund to link the transactions with an identified counterparty or a distributor with whom distribution agreements are in place, while registering the transaction on an omnibus account. At position level, daily or monthly reports will unbundle any position of the last intermediary by underlying client positions.

Figure: Parallel transaction and information flows



Despite the fact that fund promoters welcome transparency, they are aware of its limits and benefit from the administrative support of intermediaries

This model is best illustrated with an example. An intermediary has an omnibus position in a fund register. That position is composed of positions of clients A, B, and C that are segregated on the intermediary's books. The transactions can all be processed on one single account—only one account needs to be reconciled between the intermediary and the register.

The intermediary can then transfer fund positions across clients A, B or C without requiring any transaction in the register. Yet, if the transfer agent needs to know the composite parts of the omnibus position at any moment, they can do so by sourcing that information from the intermediary. This feed will be specific and will not interfere with any transaction flow.

In that same example, if the new client D wants to invest through the intermediary, he can also do so quickly without going through a full account opening process. The intermediary can check with the transfer agent that client D is trusted by the fund promoter. The transfer agent on the other hand will either be able to rely on the anti-money laundering checks primarily performed by the intermediary, or it can possibly rely on an already existing distribution contract it has separately with client D or request additional information or details. This does not need to be done in the middle of the transaction process. It is even simpler for matters like FATCA where the transfer agent can fully rely on the fact that the intermediary is a participating entity itself.

This flow of information is already in place in many cases. At Clearstream for example, all transactions are tagged with the customers' identification, including distribution contract references where applicable, and reports with the details of daily positions have been available for two decades. Other reports not only enable the transfer of information at the direct client level, but even at one or several levels above. This obviously requires input from clients on their own position unbundling.

More efficient reporting through standardisation

The original purpose of the information flows for distribution transparency of holdings was to facilitate trailer fee processing. Large distributors send their position details to each fund promoter in support of their distribution fee claims. The formats in which these position details are provided are either set by the distributors or by the promoters (or their administrators) who will both expect the other participants in the custody chain to use their formats. In addition, some will use the trade date as the reference to recognise the positions while others prefer to use settled positions. As a result, there will always be one unfortunate member of the chain who will need to reconcile and process information in various formats.

If we want to shield transaction flows from the burden of segregation, we need to ensure that the flow of information required to unbundle the positions is as automated as possible with straight-through, end-to-end processing. This requires investments in connectivity and software throughout the custody chain and such investments are easier to justify when each party is sure to receive the information in a standard format with all data elements they need.

A new ISO message format that covers these needs is in preparation. The format conforms to ISO 20022; an open and internationally recognised standard for financial messaging that can easily be certified, verified and adopted. At the time of writing, the message was in its final development stage before being submitted to the ISO. The message is expected to be authorised and published in early 2015, by which time it can be used on the SWIFT network.

Industry-wide benefits

This standardised reporting offers an efficient solution to one of the biggest dilemmas currently faced by the fund industry: overcoming the trade-off between transparency and efficiency in the custody chain. Thanks to this method of unbundling positions all the way downstream, the fund industry can benefit from both the efficiency of bundling and the transparency of unbundling, effectively providing customers with the best of both worlds under the omnibus account model.

The solution will be readily available for all players in the industry. Embracing this reporting standard might entail system investments to adapt inbound and outbound interfaces. However, the pay-off will be tremendous for the industry, not only in simplifying the exchange of information and its treatment for trailer fee processing, but also in increasing the efficiency of the transaction chains by eliminating the unnecessary segregation requirement.

To the point:

- Overcoming the trade-off between transparency and efficiency in the custody chain is a key dilemma in the fund industry
- Competing custody models: full segregation or omnibus accounting
- The solution is to maintain the custody chains as well as omnibus accounting and supplement these operational flows with reporting tools that will provide the additional information needed by the funds and their promoters
- If we want to shield the transaction flows from the burden of segregation, we need to ensure that this flow of information required to unbundle the positions is as automated as possible with straight-through, end-to-end processing
- A new ISO message format will cover these needs conforming to ISO 20022 and should be available from 2015





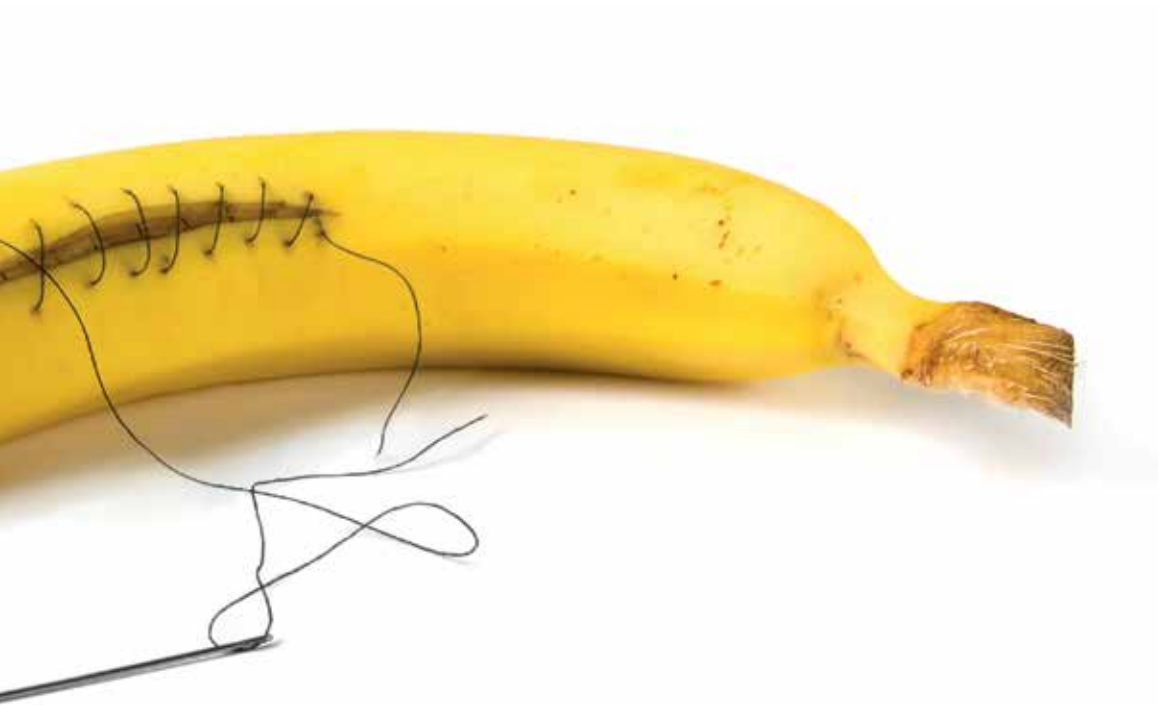
MiFID II

Should we have to fix what is not broken?

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Barely three years after the entry into force of the Markets in Financial Instruments Directive¹, the Commission launched a review not only of its 'financial market regulation' aspects but also of 'investor protection' aspects.

¹ Directive 2004/39/EC MiFID



The liberalisation of financial markets and their opening up to competition has led to poorer visibility of financial instrument pricing mechanisms and the development of trading areas lacking transparency. Conversely, the definition and oversight of investment services provided to retail and professional investors alike has led to a marked improvement in assistance provided and knowledge of the client.

The review of this Directive should therefore have focused more on financial market regulation than on investor protection. Nonetheless, the Commission wished to improve the model by seeking in particular to resolve potential conflicts of interest highlighted by CESR² on good and poor inducement practices³.

As in many sectors, the distribution of financial instruments is partially financed by product providers. Then this distributor provides the product to the investor directly. The distributor therefore provides a service both to the product provider (by seeking investors) and to the investor (by offering access to the product corresponding to his needs and objectives and potentially by providing advice). MiFID I transformed the distribution activity into a solely investor service, obscuring the product 'placement' aspect⁴. As the

distributor now exclusively serves the investor, the business model involving remuneration by the producer becomes an obvious source of conflict of interest. How can the distributor, now exclusively a service provider to the client, offer an objective service while being remunerated by product providers?

In response to this question, MiFID I called for transparency on third-party payments. The authorities now condemn this model without truly having assessed the good or bad implementation of MiFID I. An entire 'investor protection' section, whose key provisions cover the management, or even suppression, of this conflict of interest, is therefore included in the draft review of the MiFID Directive.

A new model...

Accordingly, the new MiFID II Directive⁵ includes organisational and information and reporting provisions aimed at guaranteeing investor protection. These provisions will be supplemented and clarified by delegated acts adopted by the Commission based on technical advices issued by ESMA⁶. Although not yet definitive, the Consultation Paper presented by ESMA⁷ provides insight into what could be implemented.

² Committee of European Securities Regulators

³ CESR/07-228 'Recommendations on Inducements under MiFID', May 2007; CESR/10-295 'Inducements: Report on good and poor practices', April 2010

⁴ This view of marketing differs from that presented in the Directive 2011/61/EU (AIFMD) which defines marketing as "a direct or indirect offering or placement at the initiative of the AIFM or on behalf of the AIFM of units or shares of an AIF it manages to or with investors"

⁵ Directive 2014/65/EU

⁶ European Securities and Markets Authority. At the time of drafting of this article, these technical advices are in the consultation phase. They should be published at the end of 2014

⁷ This article is based on the MiFID II Directive and the Consultation Paper published by ESMA on 22 May 2014 and does not anticipate any delegated acts or level 2 measures not yet finalised

On the ESMA point of view, all financial incentives that could alter the objectivity of the service provided to the investor must be strictly controlled or forbidden

Without anticipating which of the ESMA technical advises the European Commission will decide to adopt, the regulations impacting the distribution of financial instruments in the future can be grouped into three categories:

1. The most objective service

Drawing in particular from the British and Dutch models, the European authorities sought to eliminate all conflicts of interest that could bias the service rendered to the client. Accordingly, MiFID II forbids independent financial instrument advisors and individual portfolio managers from being remunerated by third parties for services provided. In order to avoid any bias, the independent advice or portfolio management services must be remunerated exclusively by the investor to whom the services are rendered.

For other investment services (dependant advice, but also RTO and order execution, etc.), the level 2 proposed by ESMA will supplement the model, clarifying the conditions in which monetary or non-monetary third-party payments (inducements) may be considered legitimate.

Four criteria have currently been submitted:

1. These payments do not remunerate an essential part of the Investment Service Provider (ISP) activity
2. They enhance the quality of the service provided above as required by regulations
3. They do not benefit the ISP or its employees directly, without tangible benefit to the end investor
4. There ongoing, they remunerate an ongoing service

Depending on the interpretation of these criteria, the impact on the distribution of financial instruments as a whole may be more or less significant. Numerous uncertainties remain.



In a consistent manner, these measures are supplemented by the oversight of employee remuneration policies. No more 'product of the month'!

All financial incentives that could alter the objectivity of the service provided to the investor must be strictly controlled or forbidden.

2. Abundant information

In order to reach an investment decision, the investor, whether a retail or professional client, must be correctly informed. MiFID II therefore strengthens the provisions already introduced by MiFID I regarding the provision of information that is fair, clear and not misleading, at the risk of overwhelming the investor:

Information to be provided to the client on	
Investment advice	<ul style="list-style-type: none"> • Whether independent or not, scope of products proposed, ongoing or not service, etc. • Objective of the suitability test • Where ongoing advice, changes in the allocation initially recommended • Suitability and disadvantages of recommendations (via a suitability report)
Order execution	<ul style="list-style-type: none"> • Transactions performed, including for professional clients
Portfolio management	<ul style="list-style-type: none"> • Actions undertaken and portfolio performance, etc.
Costs and charges	<ul style="list-style-type: none"> • One-off charges, ongoing charges and transaction costs relating to both the service and the products proposed • Euro amount • Ex-ante and also ex-post, where there is a continuing relationship between the ISP and the investor
The product proposed	<ul style="list-style-type: none"> • Risks, operation of the product under different market conditions, any guarantee, etc.

The investor must have exceptionally comprehensive information on the service and the product, clearly setting out the disadvantages.

3. A targeted client base

While still aimed at limiting as far as possible any mis-selling, MiFID II seeks to control product governance for both the producer and the distributor.

In the ESMA Consultation Paper, the product manufacturer⁸ ISP must implement an efficient product approval process. In particular, it must identify a target market whose needs and objectives will be compatible with the characteristics of the financial instrument.

In order to ensure effective distribution, the producer must also provide the distributor with all relevant information for a good understanding of the product.

The distributor ISP must also ensure the suitability of the instruments proposed with respect to the needs and objectives of its client base. To ensure the consistency of this model, the distributor must provide the manufacturer with a certain amount of information and in particular whether or not the product reaches the target market.

⁸ Note however that collective management is not an investment service



Despite being required to limit ties with manufacturers, the distributor ISP must contact the latter in order to determine the target market for products.

... Far-reaching consequences

It is difficult to say what upheavals or opportunities could result from a model that is not yet stabilised. It is up to the players to interpret the score. Nonetheless, studies⁹ performed in the United Kingdom and the Netherlands provide some insight into the main principles that may develop. We fully understand the willingness of European regulatory authorities to protect investors as much as possible, whether retail or professional, but it is highly possible that the saying “don’t fix what is not broken” proves true once again.

1. A two-speed distribution model

Under this new model, the receipt of third-party payments is contingent on enhancing the quality of the regulated service. However, the minimum required for the provision of such services has been significantly strengthened. What additional services could distributors propose to justify third-party payments? Access to a wide range of products or ongoing services could be a possible line of approach.

However, by significantly restricting the ability of distributors, including dependent distributors, to receive remuneration from producers, the regulation transforms distributors into providers of impartial services to investors. The business model of such service providers can only therefore be based on fees paid directly by the investor. It is therefore logical that the issue will be more critical for the most costly services (typically investment advice).

The model of third-party payments by manufacturers based on assets under management enables the mutualisation of advisory costs. The larger portfolios pay for the smaller ones. The move to a fee-based model would cancel this mutualisation, as fees are generally invoiced on an hourly basis. While it is obviously possible to base fees on the level of assets under management, this remains commercially difficult. For example:

⁹ Particularly, CFA Institute “Restricting Sales Inducements – Perspectives on the Availability and Quality of Financial Advice for Individual Investors” December 2013; Deloitte “Seismic shift in investment management – How will the industry respond?” 2014

Distribution/investment advice costs

Before		After
Assume to be 1% of assets under management		Assume to be 5 hours at an hourly rate of €300 for the suitability tests, wealth analysis, product information, etc.
€500 for a portfolio of €50,000	€2,500 for a portfolio of €250,000	€1,500 for each investor
Giving a total of €3,000		Giving a total of €3,000

Tax friction specific to each country has not been taken into account.

Moreover, the minimum required for the provision of such services has been significantly strengthened

On the one hand, the smaller investors will not wish to or will be unable to pay fees of €1,500 (compared with €500 under a commissioning model) and, on the other hand, advisors will limit this activity as unprofitable. These fees could be partially offset by product performance, as distribution costs will no longer impact performance. However, any such changes would be more or less significant depending on the market context.

A two-speed distribution model would therefore arise, with wealthier clients benefiting from investment advice and more modest clients being deprived of such services. The only recourse for the latter would be to invest without the benefit of advice through RTO or order execution platforms whose business models are primarily based on entry fees. Such business models are only viable if they process significant volumes. It would not be surprising to see substantial concentration of players in this sector, as already suggested by the Deloitte study.

2. Asset management heavily affected

The model governing commission payments to distributors set out in the new MiFID Directive only limits third-party payments, without providing any further clarification. If a third party is assumed to be any legal entity other than the investor, what savings products will ultimately be affected by this model?

Insurance products, governed by the Insurance Mediation Directive (IMD), were ultimately not considered financial instruments and as such are not covered by MiFID II. As the insurer is the legal holder of the products placed in the units of account, it is potentially to a holder, albeit a rather special one, that any commission could be paid. As to monetary ties between the insurer and any brokers, it will be for the review of the IMD to decide the legitimacy or not of these commissions.

Banking products issued by the same legal entity as the distribution network should not be concerned, as it is only a question of internal management accounting. This leaves asset management products which must, particularly in France, be managed by specific legal entities. Banking networks are a preferred distribution channel of funds in Europe, but will they continue to propose such funds if they can no longer be remunerated by the management subsidiary?

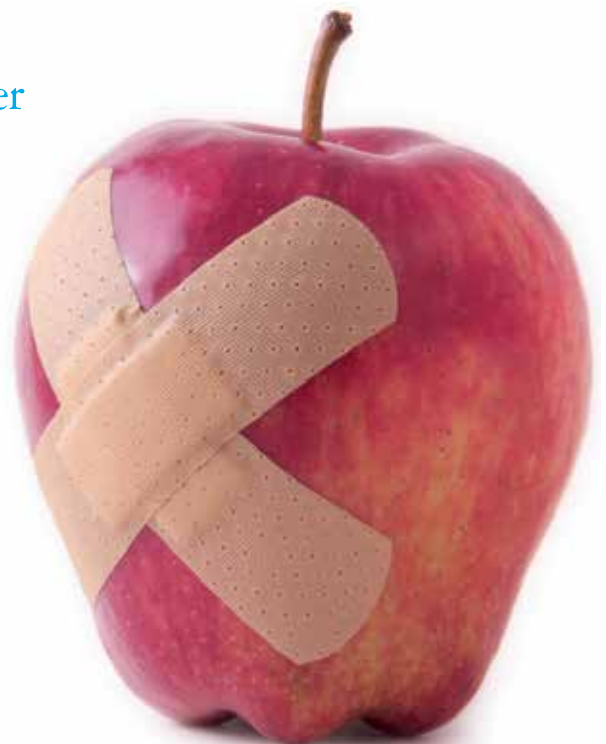
As the final text of level 2 measures has not yet been finalised and changes in the IMD are still uncertain, it is difficult to assess the real impacts of this new regulation. If insurance products remain outside the scope, this distribution channel is likely to develop in the coming years. However, only the ban on independent advisors and fund managers is currently certain. As long as other investment services, and particularly dependant advice, are not affected, distribution via the banking networks can continue.

While this new version of the MiFID Directive would appear to penalise primarily asset management, it may also offer the opportunity to establish asset management as a separate sector in the eyes of the general public. By making investors the focus of attention of management companies and obliging them to shorten the distribution chain, or even distribute their own products, will MiFID be the catalyst for change in this sector?

In conclusion, a two-speed distribution model would therefore arise, with wealthier clients benefiting from investment advice and more modest clients being deprived of such services

To the point:

- The retrocession model and its potential conflict of interest are highly questioned by European authorities
- The fund distribution channels will completely change. It is likely to benefit a vertical integration
- The open architecture is expected to disappear
- A two-speed distribution model is likely to be implemented to respond to the ban on inducement



Open architecture must remain a fundamental right of the European investor The point of view of Guillaume Dard

Chairman and CEO of Montpensier Finance since January 2004 and previously Chairman of Banque du Louvre, a pioneer in multi-management in France.

The European investor has progressively gained freedom of choice of investment over the last 20 years, in the same way as the consumer was previously offered a wider choice of products and brands with the arrival and development of hypermarkets and specialist stores in the 1960s and 1970s.

Investors under 45 years of age cannot imagine that in the past they would have been obliged to subscribe only 'in-house' products offered by their banks. The consumers of 2014 would similarly not accept to be limited to 'distributor' brands!

Today investors potentially enjoy an immense choice: the European investment solutions offering is extremely abundant. For example, the European asset management industry proposes over 55,000 funds totalling assets under management of approximately €8,000 billion¹⁰. It is of course crucial to guide savers in their choices.

Enabling each investor, and particularly retail investors, to find the allocation corresponding to their needs must be a priority for professional and regulatory players. It is therefore necessary to incite distributors to offer the widest possible range of products, thereby encouraging an open architecture; while ensuring investors are assisted by professionals of the highest calibre.

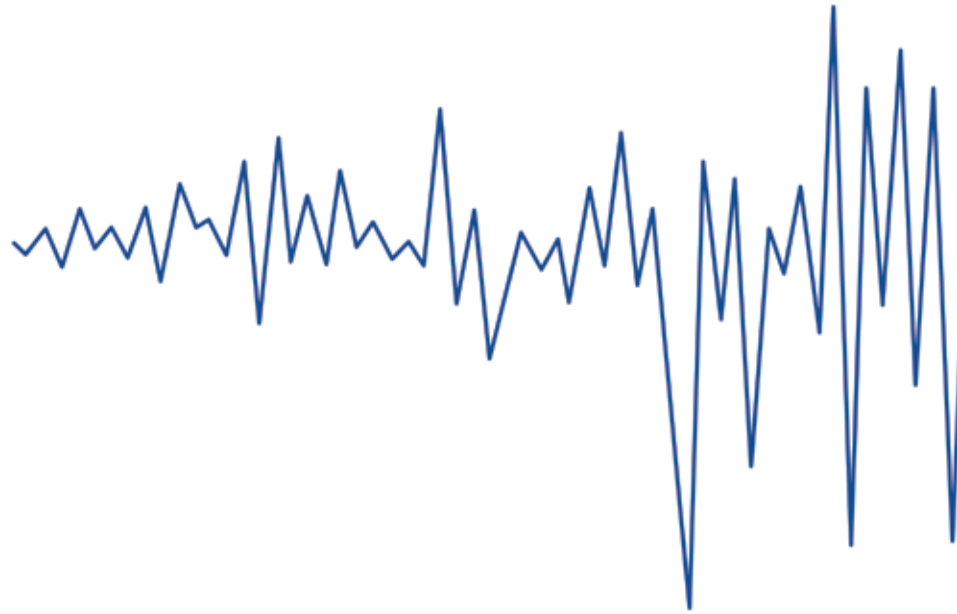
Are these priorities fully taken into account in the new Directive? It is not clear as it is feared that the new provisions on retrocessions may lead major banking distributors to bring management products back in-house, resulting in the progressive disappearance of the open architecture.

It is also essential to ensure that financial investment advisors, who currently propose external products, do not seek to develop 'in-house' product offerings for their clients and are not encouraged to change their legal status.

The initial intention of the European legislator is surely to protect the investor. The risk is that the latter is inadequately assisted in his choices, that is, if there remains a real choice in the long term.

A solution involving real transparency on third-party payments received by distributors would probably have been the best way forward. This model has the major advantage of truly favouring an open architecture and therefore the possibility for the investor to easily find a sufficiently diversified offering to meet his needs and characteristics. The open architecture must remain a fundamental right of the European investor.

¹⁰ Ejama 'Asset Management in Europe – Facts and Figures', June 2014



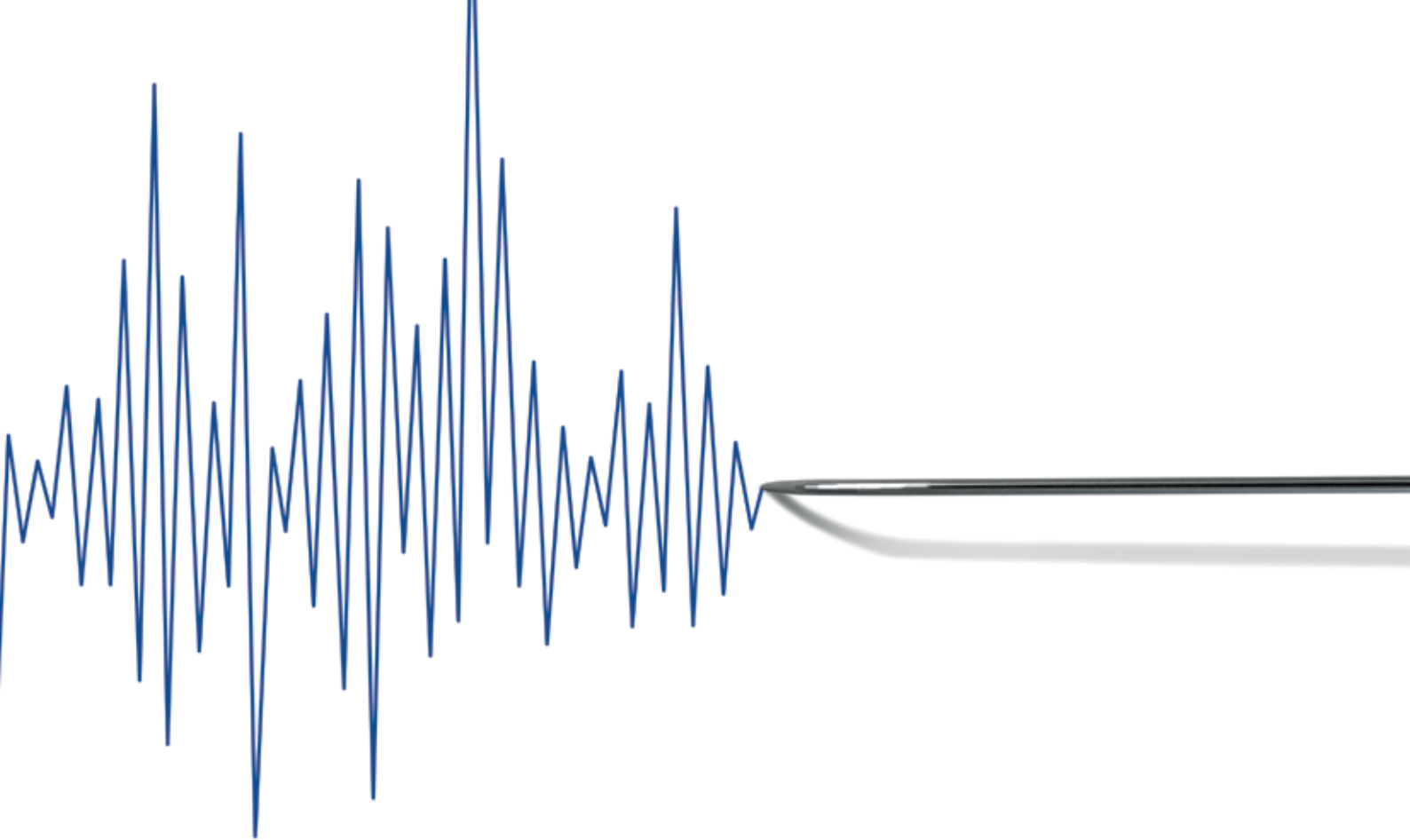
Seismic shifts in investment management

A look at the UK market

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The UK investment management industry is at a turning point. Traditional active managers have already had to adapt to changes in the institutional market, but now they face a confluence of trends—from regulation to pension auto-enrolment to the growth of passive investing—that could also radically reshape the retail side of their industry.



As the industry experiences these seismic shifts, several key trends emerge.

- **Retail-isation:** with pension liabilities around the world moving from the state and employers to the individual via defined contribution schemes, retail investors are becoming increasingly important. As retail investors are generally poorly engaged with investment decision-making and often use the default funds offered by their pension provider, becoming the default fund is an extremely attractive prospect—regular, large fund flows that are likely to remain in place for decades are an asset manager’s ideal. But the market requires scale to penetrate.
- **New intermediation models:** asset managers who have historically controlled a significant part of the value chain are in danger of losing out as platforms, wealth managers, insurance companies and other parts of the chain all aim to control a larger slice of the cake. These intermediaries—made up of around 150 decision makers—are acting as ‘gatekeepers’ by standardising the criteria for fund selection and launching their own funds, sub-advised by asset managers. This is significantly concentrating fund flows and putting pressure on fund charges, with many asset managers struggling to differentiate themselves and justify their fees in the eyes of these powerful new intermediaries.
- **Internationalisation:** asset managers are adapting to demands from UK investors for increasingly global products. At the same time, wealth in emerging markets is growing, creating new client bases for asset managers in these local markets.
- **Pricing and cost pressures:** pricing pressures are coming from several sources. Platforms that directly compare funds can force down fund management charges. In addition, the continued growth of low-cost passive funds can directly challenge those active funds that only achieve ‘marginal alpha’. Regulatory costs add to this pressure.

Research, including interviews with a number of senior executives at asset management companies operating from the UK, suggests that the key industry responses to these trends are as follows:

- **Distribution:** asset managers are faced with a choice between building direct retail businesses and strengthening intermediated approaches. The majority of asset managers interviewed stress the importance of building deeper partnerships with their intermediaries as their primary route to market.
- **Products:** asset managers targeting foreign markets are using two approaches—either taking out UK-manufactured products via global distribution networks or building a domestic presence in a smaller number of regions using specifically targeted products. Active managers are also repositioning alpha products in light of the growth of hedge funds and pricing pressures from lower-cost passives, with many choosing to offer either higher, more differentiated alpha performance or lower-cost, semi-active funds with reduced costs.
- **Pricing:** interviewees accept that there is significant pricing pressure on UK-focused asset managers and there is evidence of fees being reduced in places. However, most are seeking ways to reduce prices only selectively by moving to variable pricing models, such as pricing by type of product (actives establishing higher prices for complex products and lower prices where automated processes can be introduced), by style of fund and by type of distributor (discounting only for the largest independent financial advisers but sustaining price differentials with smaller intermediaries). Avoiding wholesale reductions in pricing is the name of the game.
- **Costs:** to date, many firms have introduced cost-cutting and more disciplined spending regimes. Although interviewees display an appetite for more radical cost savings through outsourcing, they are struggling to understand which functions are key. Outsourcing data to cap escalating data costs raises concerns about cyber risk and regulatory requirements.

The UK investment management industry is undergoing extensive and continued structural change that will create a 'winner takes all' competitive environment. Similar to in the U.S., Australia and the Netherlands, the UK's move towards encouraging individuals to save into a pension, alongside the increasingly global and competitive nature of business, will radically reshape the industry and the role of asset managers within it.

Against this backdrop, Deloitte LLP commissioned The Economist Intelligence Unit (EIU) to analyse the drivers behind the seismic shifts shaking up the UK market and to explore how UK-based global traditional asset managers are responding. The research included interviews with a number of senior executives at global asset management companies operating from the UK.

Many of the trends identified in the research are already evident in other markets and will become increasingly marked as regulators and governments across the world seek to improve customer outcomes in investment management and tackle the high cost of public sector pensions. To read the full report, please visit: www.Deloitte.co.uk/Seismicshifts.

The Deloitte view

It is clear from the research that the seismic shifts occurring in the industry and across an asset manager's value chain are revealing white-space opportunities and threats. Asset managers with a presence in the UK need to understand where the industry is headed and adapt their model for these long-term changes to stay ahead of the competition.

Given the drivers identified in this research, we believe asset management boards in the UK have four sets of strategic choices to make:

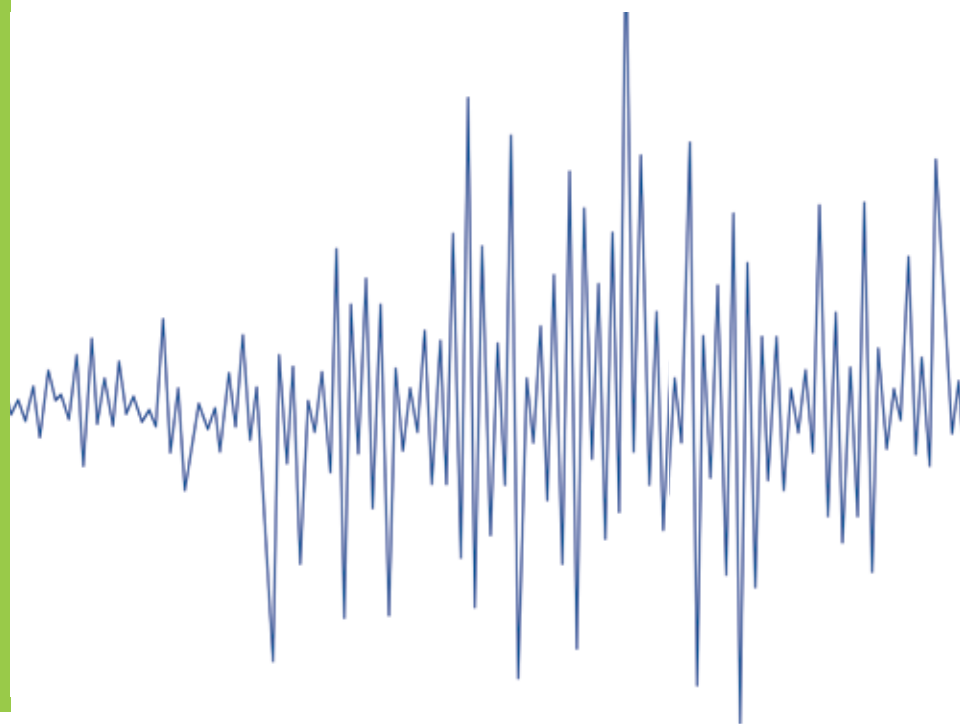
- What client segment mix will be optimal—retail or institutional?
- Which distribution model will best achieve goals—direct or intermediated?
- What should be the preferred product and management style—active or passive?
- How best to capture demographic change—configure for local or global markets?

Building a picture of how these factors will interact will be key to deciding competitive strategy and scenario planning over the next 3-5 years.

View the full report at www.Deloitte.co.uk/Seismicshifts.

To the point:

- The UK's investment management industry is at a turning point, as retail flows become the predominant driving force
- The distinction between retail and institutional is blurring; funds are retail, but decision-making becomes more institutional
- Regulation, pension auto-enrolment, the growth of passive investing and platforms along with the increasingly global and competitive nature of business is radically reshaping industry
- These seismic shifts present both white-space opportunities and threats for asset managers with a presence in the UK. Winners are likely to have scale or be in niches



The people agenda

What is keeping asset managers awake at night?

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Financial Services Reward
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Director
Organisation, Talent
& Transformation
Deloitte



As we step out of the shadows of the economic downturn and into an environment where firms are focused on growth, people strategy challenges and solutions can be found near the top of most corporate agendas. For asset managers, where people form a significant portion of their overall cost base, this rings especially true.

What a successful people strategy looks like will vary from firm to firm; however, demographic shifts, technological advancements and regulatory pressures are creating some very clear challenges for all asset managers. Against this backdrop, Amy Titus, a director in Deloitte LLP's U.S. Organisation, Talent and Transformation Practice, and Helen Beck, a partner in Deloitte LLP's UK Financial Services Reward team, outline the biggest issues on the people strategy agenda for asset managers in the U.S. and Europe and suggest how asset managers can respond.

Key people strategy challenges

Regulatory pressures on reward

The global asset management sector has seen an increasing number of regulatory demands focused on firms' approaches to reward. These demands have not always been consistent from country to country, which has created further complications for those asset managers operating globally.

In Europe, asset managers need to comply with reward rules stipulated in the CRD¹ III and IV, as well as the AIFMD² and UCTIS³ V, while in the U.S. firms are guided by FATCA⁴ and the Dodd-Frank reforms, including the Volker Rule. It should be noted that in the U.S. there is a movement towards a uniform fiduciary standard for broker-dealers as well as investment advisers; today they operate under different regulatory regimes and standards—for broker-dealers it is the less stringent 'suitability standard' whereas investment advisers are held to 'fiduciary standards'. This has significant implications for business models for broker-dealers and investment advisers.



The good news is that these regulatory requirements are largely based on the same principles, however, the introduction and application of these principles has varied. Specifically, European regulations are structured to apply to all asset management firms, whereas the U.S. rules affect only firms with 'consolidated assets' exceeding US\$ 1 billion. Also, while the U.S. and European regulations address three areas that are broadly similar – transparency, engagement and accountability—in application the European regulator has been more prescriptive with regard to deferral levels and compensation structures, as applied in AIFMD and UCITS.

The challenge facing asset managers in both the U.S. and Europe is how to maintain their chosen reward strategy within a prescriptive regulatory framework. Firms across the board are responding by restructuring compensation plans to align reward with long-term performance and adjusting for risk (e.g. by deferring bonuses over longer periods of time, tying bonuses directly to objective measures of risk or balancing the reward structure with corporate shares and fund units).

To ensure compliance with these U.S. and European regulatory requirements and to mitigate risk effectively, asset managers should conduct broad assessments of their governance and risk management programmes and put mechanisms in place to periodically evaluate these programmes (including governance committee structures, roles, decision rights and processes) to drive effective decision-making, risk management and transparency. Global organisations can also look to centralise governance of total reward programmes, a measure that enhances cost management, compliance and overall effectiveness.

Attracting and retaining millennials

Asset managers are facing fierce competition to attract and retain quality talent, both from within and outside the financial services sector. Some have found themselves outdone by their banking, insurance and technology counterparts on college campuses

and in social media—platforms critical to ensuring engagement with the youngest group of individuals joining the workforce.

In order to reduce this gap and effectively attract and retain millennials, firms must look at their talent programmes all in all—this means from talent acquisition through to managing the post-employment relationship, and every step in between. Many firms are increasing their investment in community projects and social platforms (online and in person) to bring millennials together to experience their brand. Once employed, organisations are increasingly promoting continual opportunities for learning and development, embedding extended leave programmes, career breaks and flexible working arrangements into people programmes to satisfy millennials' needs and expectations.

Building the right technological capabilities is also now a prerequisite for firms to effectively attract and retain new employees with cutting-edge skills, and also to more effectively deliver essential tools, information and development opportunities to existing employees in order to stay competitive. For example, sales and field representatives are demanding mobile solutions to quickly access information and learning when, where and how they need it. Employees, particularly millennials, are requesting rapid ways to connect using social media. They want compelling and user-friendly internal collaboration tools for their own productivity and development and recognise the need to deliver an equally positive experience to their clients through such platforms.

Need for new organisational capabilities and employee skills

In order to succeed in an increasingly global and competitive world, organisations are centralising operations and emphasising collaboration – essentially 'busting down the silos'. This means that challenges facing asset management firms must now be addressed by an integrated cross-section of expertise.

1 Capital Requirements Directive

2 Alternative Investment Fund Managers Directive

3 Undertakings For The Collective Investment Of Transferable Securities

4 Foreign Account Tax Compliance Act

The global asset management sector has seen an increasing number of regulatory demands focused on firms' approaches to reward and conduct





Global organisations can also look to centralise governance of total reward programmes, a measure that enhances cost management, compliance and overall effectiveness

These changes have required organisations to develop new skills and capabilities across lines of business and functions. Adding to this is the increasingly informed customer base and ever advancing technology, which is also changing the demands placed on different functions. Within HR, one of the most important and salient examples of this involves the need for managing data and providing HR analytics to enhance decision making, which has become a top priority for many European asset managers and is slowly emerging in the U.S. as well. In this new world, HR functions need to become strategic and proactive business partners, tightly aligned to business priorities. In order to do this, they need to strengthen their advisory and analytical skills, business partnership capabilities, business and product acumen, and functional and regulatory insights.

Further to this, as both the European and U.S. markets start to seriously focus on growth, many firms are looking for new recruits who will challenge the status quo and encourage leaner and proficient business models. To accomplish this at a senior level and effectively align the sourcing and recruiting of new talent with strategic priorities, firms must ensure the recruitment process both clearly communicates the firm's strategy and has input from all areas of the business, including marketing, sales, technology, operations, risk and trading.

Succession planning

The imminent retirement of many existing leaders, a lack of a broad diverse leadership pool, the impatience of the few future leaders in waiting, and finally Boards demanding accelerated growth after years of stagnation, have combined to make succession planning the single biggest concern for some asset management boards.

This is not, however, a stand-alone issue for asset managers: in Deloitte's 'Global Human Capital Trends 2014', over half (51%) of the executives surveyed across industries have little confidence in their ability to maintain clear, consistent succession programmes. Particularly challenging for asset managers are new regulations which impact the extent and methods by which top-performing leaders can be remunerated. These increased restrictions, particularly in Europe where regulators are more prescriptive, through AIFMD and UCITS, make it more likely that the most effective leaders will move firms to seek better reward packages.

In order to tackle this growing leadership gap and other succession planning challenges, firms first need to either proactively develop their own 'home grown' talent or develop an organisational culture which ensures that senior external hires will bring positive change. For 'home grown' talent, some firms are building their own leadership programmes to develop leadership capabilities, generally designed and developed in partnership with outside organisations that specialise in leadership development.

To support experienced leaders hired from other firms, organisations must first develop a comprehensive leader integration programme that goes beyond typical onboarding. For example, external hires could join an advisory council of other leaders and colleagues within the organisation and receive regular one-on-one coaching and mentorship from a senior leader to help them navigate and accelerate within their new environment.

Conclusion

Successfully addressing these challenges, and ensuring a good night's sleep, will likely require asset managers to commit to a clear talent agenda grounded in their organisations' business strategy. In order to adapt to dynamic customer needs, employee expectations and global regulatory changes, asset management firms

need to attract, retain and develop high-performing talent, and to reinforce the organisational values and capabilities necessary to ensure both premier performance and appropriate conduct. The particular importance of culture and values as enablers of regulatory compliance is now at the centre of a number of asset management boardroom discussions, and talent strategies need to reinforce this shift. Done well, this can also foster a strong sense of internal cohesion.

The talent agenda is now broader and more essential to success than ever before, since reward is no longer the silver bullet. In order to succeed, firms need to consider the whole employee proposition.

To the point:

- The talent agenda is now broader and more essential to success than ever before, since reward is no longer the silver bullet
- Regulatory demands are placing pressure on firms and these demands are not always consistent country to country, which creates added complications for those firms which operate on a global basis
- Compliance with regulation can, however, be used as an opportunity; global organisations can look to centralise governance of total reward programmes, a measure that enhances cost management, compliance and overall effectiveness
- Building the right technological capabilities is now a prerequisite for firms to effectively attract and retain new employees with cutting-edge skills and to remain competitive in the eyes of existing employees
- To tackle the growing succession planning gap, firms need to either proactively develop their own 'home grown' talent or develop an organisational culture which ensures that senior external hires will bring positive change
- In order to implement a successful people strategy, firms need to consider the whole employee proposition and one that is grounded in their organisations' business strategy



On 1st August 2014, ESMA published in all EU official languages its revised guidelines on ETFs and other UCITS issues ('ESMA 2014/937') modifying the provision on diversification of collateral and related disclosure in the annual report. This publication triggers the application date of the revised guidelines as from 1st October 2014, however, UCITS that exist before application date of the revised guidelines have 12 months to comply with those modified paragraphs 43(e) and 48. They should update their prospectus with the revised provisions on collateral diversification at the earlier of the first occasion on which the prospectus is revised or 12 months after the application date of the guidelines.

Guidelines on collateral management

On 18th December 2012, the ESMA had initially published guidelines on ETFs and other UCITS issues introducing new risk management and transparency requirements for UCITS and amongst other imposing

diversification criteria for collateral received by UCITS in terms of country, market and issuers. Specifically, the criterion of sufficient diversification with respect to issuer concentration was considered to be respected if the UCITS received from a counterparty of efficient portfolio management and over-the-counter financial derivative transactions a basket of collateral with a maximum exposure to a given issuer of 20% of the UCITS' net asset value, irrespective of the quality or soundness of the issuer.

Criticised collateral issuer diversification rules

The application of this 20% limit to collateral received in the form of securities issued by governments was largely criticised by the industry as securities issued by governments were widely used by asset managers and their counterparties in their operations and considered as sound risk mitigation and in the best interest of shareholders protection.

Revised guidelines

Taking into account industry concerns, on 24 March 2014, ESMA issued its final report on the revision of the guidelines granting some flexibility on rules for diversification of received collateral when composed of transferrable securities or money market instruments issued by governments or their bodies.

In the revision of its guidelines, ESMA basically aligns diversification rules applicable to transferrable securities or money market instruments issued by governments or their bodies held as collateral with those applicable when directly held in portfolio. As such, UCITS are entitled to hold securities issued by a single government up to 100%, provided that the UCITS holds securities from at least six different issues and none of these issues account for more than 30%.



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- Remuneration: Key Developments and Considerations for Fund Managers - 2015 Date TBC
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- FATCA implementation - 2015 Date TBC



Regulatory

- EMIR - 2015 Date TBC
- MiFID II: Implications for Fund Managers - 2015 Date TBC
- Development in Client Asset Requirements - 20 NOV
- BEPs & Tax Updates - 09 OCT
- European regulatory update - 23 OCT



Operations & Techniques

- Principles of Share Class Allocations and FX hedging - 2015 Date TBC
- Focus on Annual Reporting for 2014 year end - 06 NOV



Investment Funds Introduction

- Introduction to Investment Funds - 2015 Date TBC
- 2015: A strategic outlook for the Investment Management industry - 04 DEC

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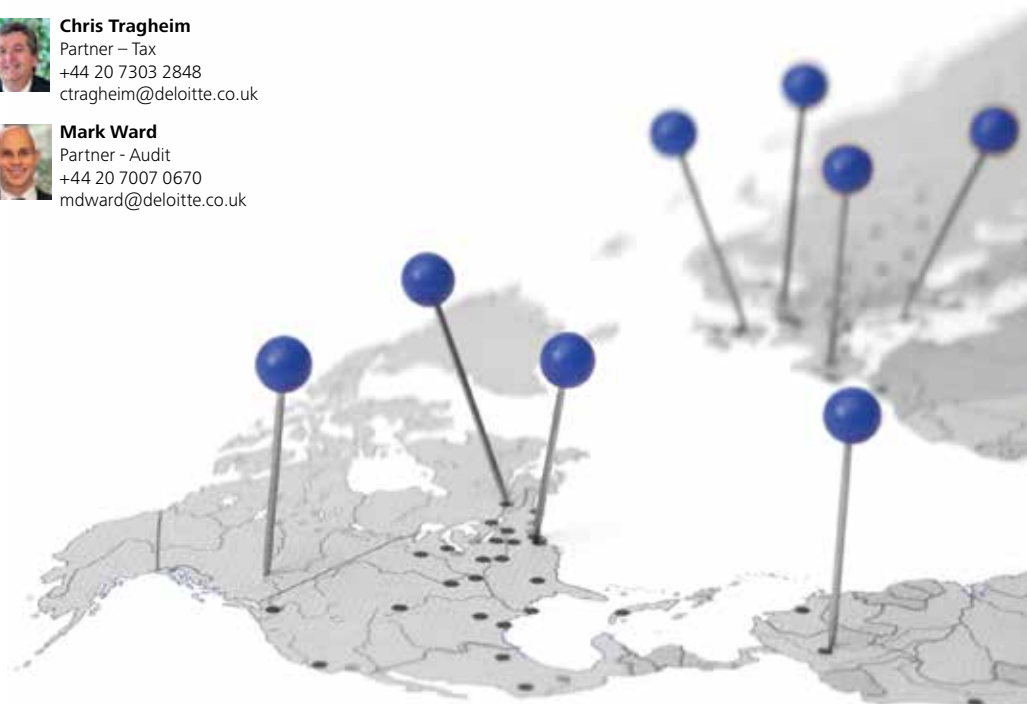


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