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Foreword



Time stands still for no one and the offices of Deloitte are no exception. Although the long summer holidays are coming to a close in Europe, we've continued to connect with our colleagues and esteemed audience to compile another packed edition of Performance Magazine, full of the latest trends, developments, and insights within our ever-evolving industry.



From our readers' perspectives, this edition's articles focus on Private Equity Bridge Financing—an increasingly popular option to provide greater flexibility to management companies to control profitability. As with many such innovative solutions, they come at a price. For bridge financing, this is increased investor transparency and full disclosure.



Continuing our focus on China, we present the results of the pioneering work conducted by Deloitte China with AMAC in 2018 on the state of the Private Securities Investment Sector. It is one of the fastest growing segments but one not without its share of challenges to be mastered. Turning the spotlight to regulations, we delve into Chinese-style enforcement with its two classifications—weak or strong. As ever in any country, a thorough understanding of the ongoing changes in the regulatory environment is key to successful investing.

This brings us to the buzzwords and acronyms for the foreseeable future; no doubt Brexit, equivalence and delegation will dominate, however, others continue to emerge from the shadows in the form of Green, BMR, and ESG. We all know

from our daily lives that it's not easy being green, but that is exactly what the European Commission is encouraging us to do in the form of financing sustainable growth. Earlier this year, it published its action plan with ten initiatives, including introducing consistent and clear taxonomy. After all the color green does come in many different shades. ESG is also gaining momentum and will certainly be on the radar for 2019.

Turning to BMR (Benchmark Regulation), our in-depth guide will help you determine if you really are a benchmark user or have impacted products in your investment universe. Interestingly, who would have thought that simply referencing a benchmark for performance comparison would not actually constitute benchmark usage?

Last but not least, remaining on the topic of regulation, have you ever wondered how we at Deloitte keep up-to-date with the pace of the rapidly evolving regulatory landscape? Of course, through our own dedicated Kaleidoscope RegWatch team that analyzes hundreds of pages every month while scouring dozens of internet pages. Read on to find out some of the intriguing cyclical trends that we have discovered.

All that remains is to say we hope you enjoy reading this edition of Performance as much as we enjoyed compiling it.

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Editorial

Dear Readers,

“How do you describe the asset management market in China?” I have been asked this question many times over the past few years.

Since the launch of Qualified Foreign Institutional Investor (QFII) in 2002, Chinese securities regulator CSRC has put forward half a dozen schemes to encourage capital flow across borders aimed at continuously expanding its market.

To name but a few, since 1 July 2002, China allowed foreign fund managers to participate in joint venture mutual fund management companies in China, and China Merchants Fund, which was founded in December 2002, becoming the first mutual fund joint venture managers established in China. By 2005, foreign investors' can increase their maximum shareholding in a joint venture mutual fund companies in China from 33 percent to 49 percent. As of July 2018, there are 118 mutual fund management companies in total, among which 44 are joint ventures.

QFII and QDII have witnessed a booming growth. According to CSRC, by the end of July 2018, there are altogether 207 QFIIs and 113 QDIIs. According to the State Administration of Foreign Exchange (SAFE), the total approved investment quota for QFII has reached US\$101 billion and US\$46 billion for QDIIs.

In 2008, various municipalities in China also started introducing QFLP programs in attracting foreign private equity managers, which enables foreign private equity managers to raise funds and invest in on shore markets. QDLP is a program for

foreign hedge fund managers to raise funds onshore and invest offshore.

As recent as 2017, foreign fund managers are allowed to own 100 percent of onshore management companies through a CSRC approved wholly owned foreign entity (WOFE) scheme.

Sixteen years of expanding certainly encouraged collaboration opportunities for asset managers around the world to gain some first-hand knowledge of the Chinese asset management industry. However, if not living in it, one often feels a bit difficult to keep up with the development of the market's constant changing conditions, as well as regulatory changes issued by state and local authorities, and it seems that every single change would have an impact on fund raising, product design, regulatory compliance, and fund financial performance measures, to name a few.

In the last Performance issue, we provided a brief overview of the current regulatory framework in China for private securities funds. In this edition, we have three articles covering the Chinese Asset Management Industry: opportunities in the eyes of a veteran industry executive, continued update for the private securities industry in China, and how the regulatory enforcement is taking shape in China from a well-respected attorney. I hope this provides a balanced update to the current Chinese Asset Management Industry.

So how do I describe the Chinese Asset Management industry? Very dynamic economic and regulatory environment, often poses challenges, and can be frustrating. However, it is certainly a growing market with tremendous potential.



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Recent Dynamics of Private Securities Investment Funds in China

Jennifer Qin

Partner
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Following the inaugural official report of the Private Securities Investment Fund (PSIF) industry issued at the beginning of 2018, Deloitte China was honoured to be invited again to take part in the annual PSIF industry report 2017, which is expected to be published in the second half of 2018. We have summarized some highlights from the preliminary analysis of the 2017 data in comparison with the prior year's data. Please refer to the official website of the Asset Management Association of China (AMAC) (www.amac.org.cn) for the full official report. If there is any discrepancy between the data quoted in this article and the official report released later, the official report shall prevail. ➤



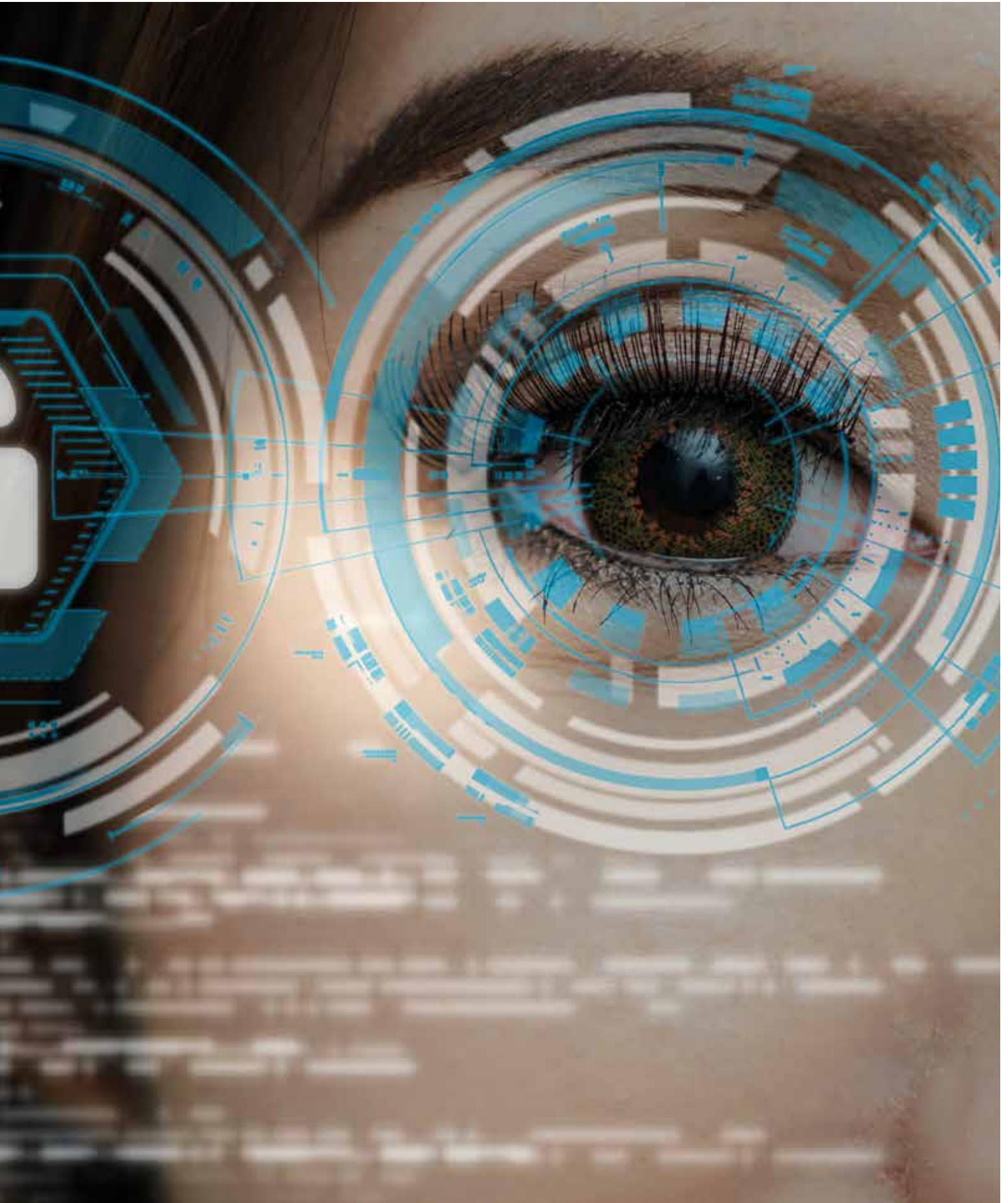


Figure 1-1-1a: Changes in manager numbers and AuM from 2014 to 2017

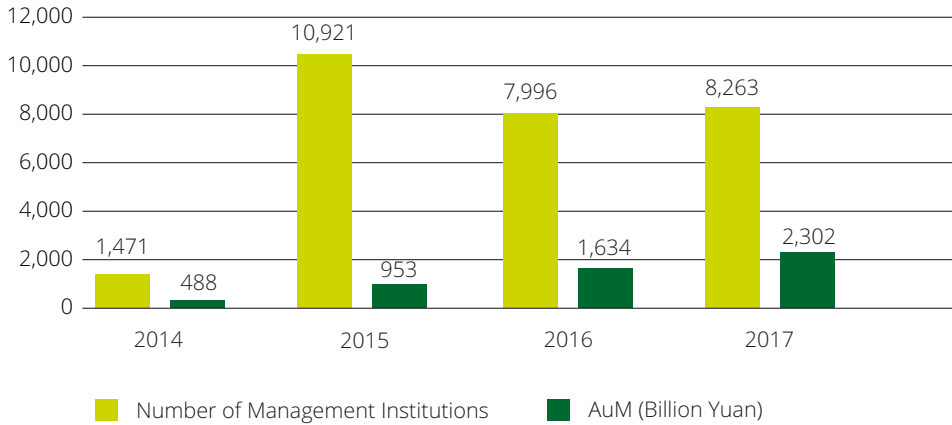
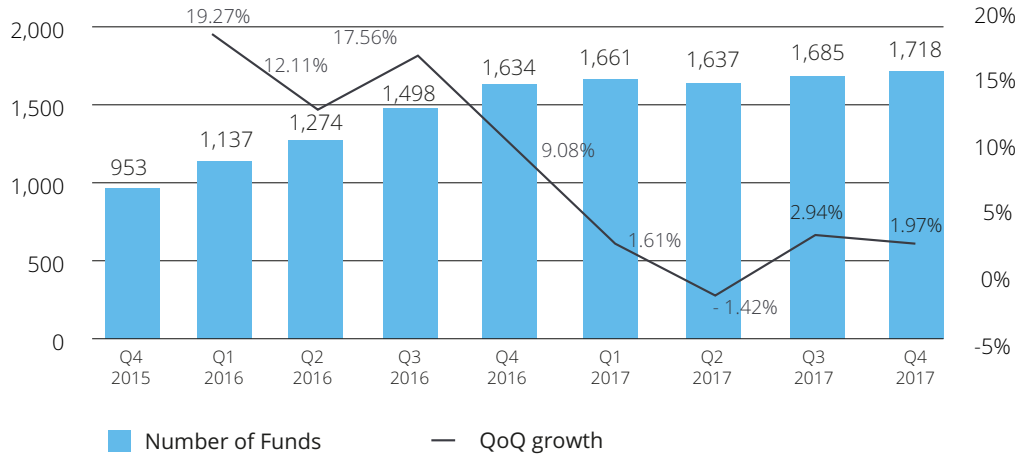


Figure 1-1-1b: Growth of the scale of filing for PSIFs (total asset under management in billions)

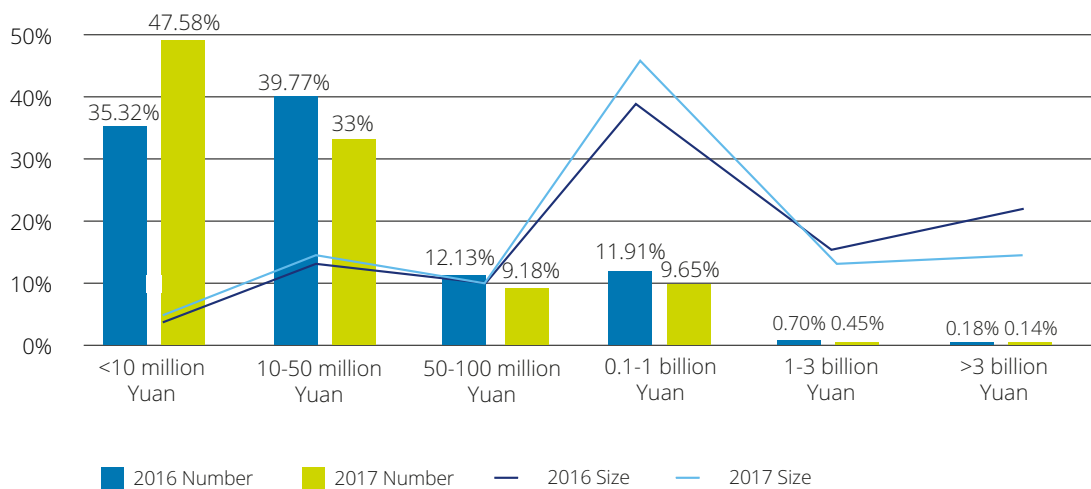


By the end of 2017, a total of 8,263 PSIF managers were registered with AMAC, of which 12 were foreign managers under the Qualified Domestic Limited Partners (QDLP) program. QDLP is a program introduced by the Finance Service Office of Shanghai, which offers foreign managers the opportunity to raise funds from domestic Chinese institutional investors and qualified individual investors to feed offshore investment funds.

As illustrated in Figure 1-1-1, the PSIF sector grew steadily throughout 2017 with a slower growth rate. This is partly as a result of a series of new measures by AMAC for more strict admittance requirements following the clean-up of domestic fund managers back in 2016. However, the amount of total assets under management increased by 40.88 percent while the increase in number of funds was less than one percent.



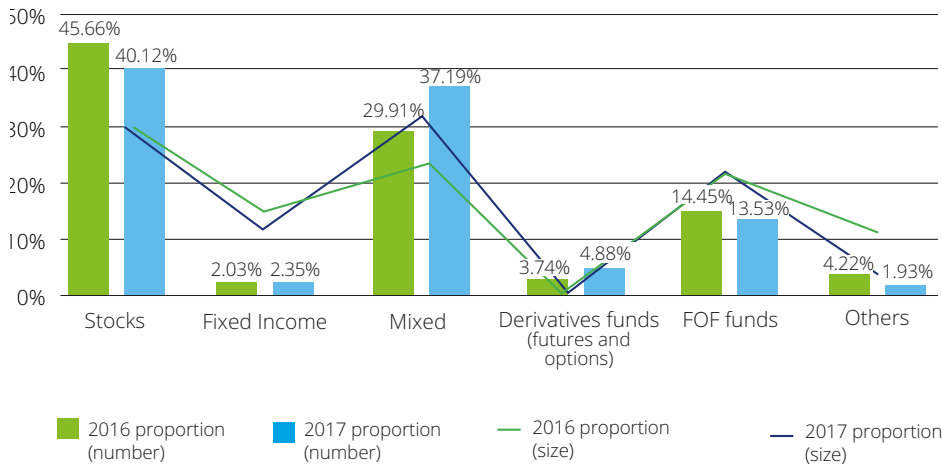
Figure 1-1-2: Proportions of the number and assets of PSIFs in terms of size by 2017



As illustrated in Figure 1-1-2, at the end of 2017, the fund size of less than 10 million yuan became the number one choice for the fund managers, with almost half of the funds with size in this category, while there was only 10 percent of the funds with a size of over 100 million yuan. This trend may also suggest the investors' preferences, especially that small-scale funds may allow lower entry thresholds. ➔

This trend may also suggest the investors' preferences, especially that small-scale funds may allow lower entry thresholds.

Figure 1-1-3: Proportions of the number and size of PSIFs with different product type

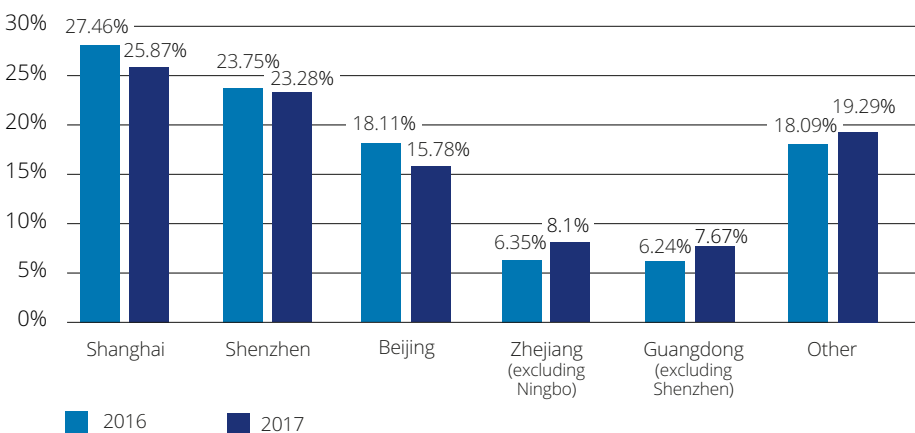


Another preference of the investors can be seen from the type of investment products. In line with the prior year, almost 90 percent of the funds were focused on stocks, mixed (stock and bonds), and FoF funds, while mixed strategy overtook stocks as the most popular investment strategy of PSIFs in terms of both number

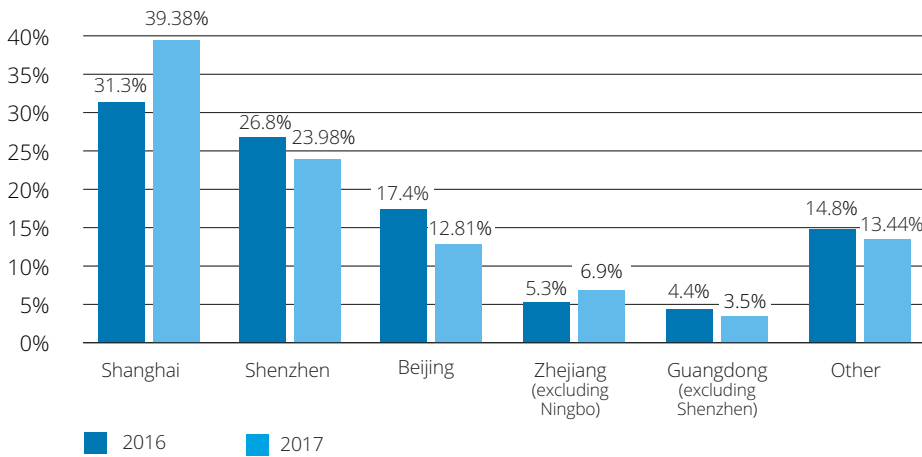
and scale of all PSIFs. The emerging position of FoF still looks promising with the size of funds steadily growing to 22.06 percent, which shows that reliance on professional intermediaries by qualified investors and institutional investors was on the rise.

In line with the prior year, almost 90 percent of the funds were focused on stocks, mixed (stock and bonds), and FoF funds, while mixed strategy overtook stocks as the most popular investment strategy of PSIFs in terms of both number and scale of all PSIFs.

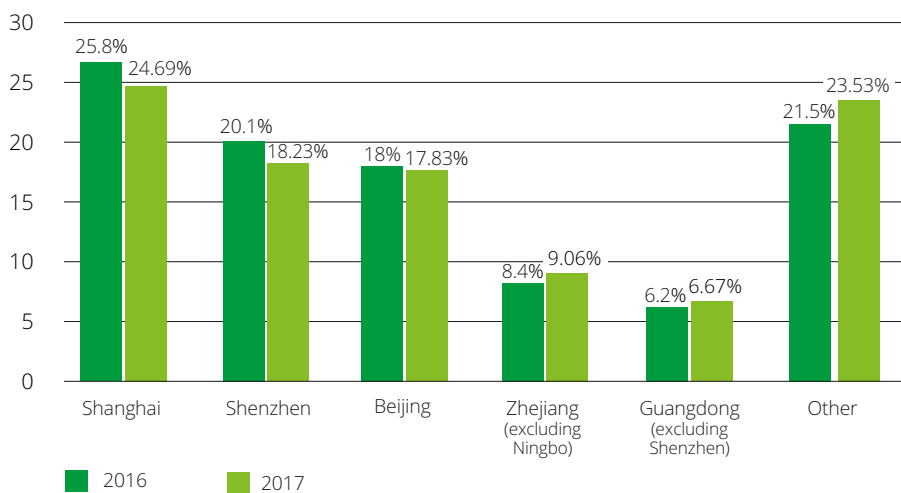
Figure 1-1-4: Top five operational regions in terms of number and AuM Proportion (number in registered locations)



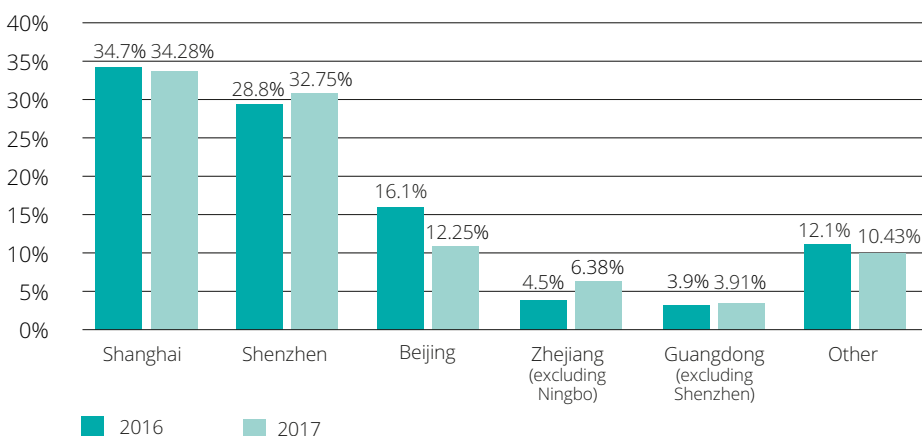
Proportion (AuM in registered locations)



Proportion (number in business locations)



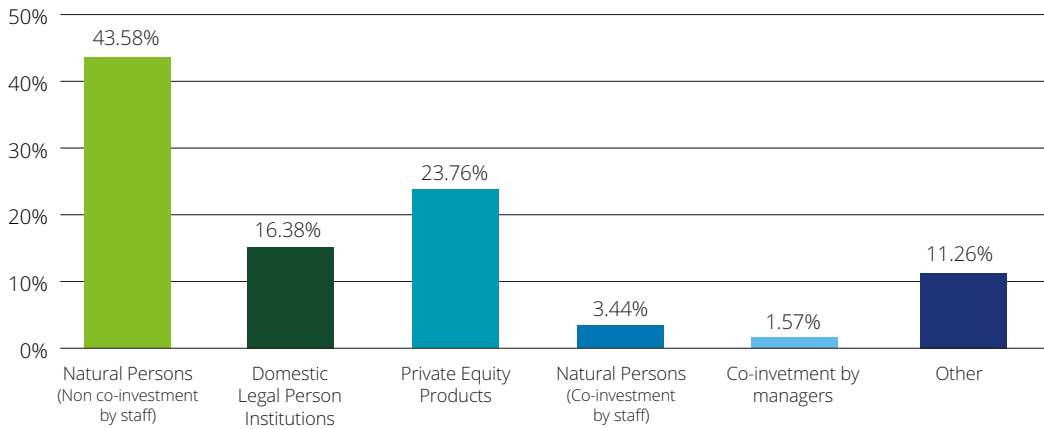
Proportion (AuM in business locations)



Shanghai's position in the PSIF industry has consolidated in 2017, being the most sought after place for registration and the AuM size has overtaken Beijing by more than 15 percent.

As shown in Figure 1-1-4, the development of PSIF managers represents strong regional characteristics, as those mega cities provided a more appealing environment not only from the perspective of talent, but also regarding infrastructure, pool of funds, and business community, among other factors. Shanghai's position in the PSIF industry has consolidated in 2017, being the most sought after place for registration and the AuM size has overtaken Beijing by more than 15 percent. ➔

Figure 1-1-5: Source of funds



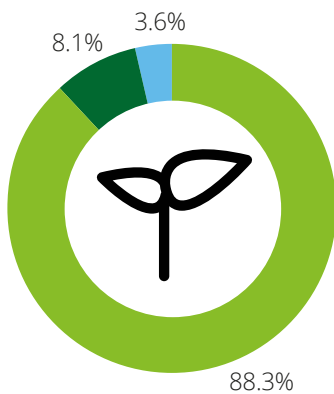
The source of funds from natural persons grew from 37.33 percent in 2016 to 43.58 percent in 2017. This shows an ever-increasing level of personal wealth and that PSIF investment has become a more common investment channel for more high-net-worth populations.

In terms of the fund raising channel of the PSIF funds, it is either through self fund-raising by the fund managers or through

the entrustment to the fund raising agents. However, as shown in Figure 1-1-6, as of end of 2017, 88.13 percent of the funds were self-raised by the fund managers, only 8.1 percent of the funds were purely sold by the entrusted agents. This on the other hand shows that a lot of fund managers, especially the smaller fund managers are facing pressure from the fund raising channel and self-raising is the only route they could choose.

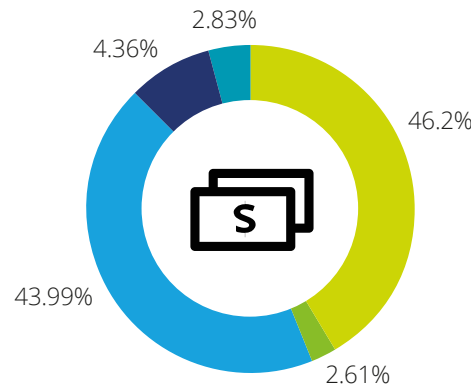
With regards to the fund expenses of the PSIF funds, we can see from Figure 1-1-7 that management fee and performance-based compensation takes the top two positions. Service fees in relation to custodian and outsourcing takes very small portion and this also shows that the outsourcing services are limited and may have more potentials to explore.

Figure 1-1-6: Fund raising channels



- Self-raising funds
- Entrusted fund raising
- Mixed fund raising

Figure 1-1-7: Fund expenses analysis



- Management fee
- Performance-based compensation
- Investment advisory fee
- Custodian fee
- Operating service fee/Outsourcing service fee

Figure 1-1-8: Quantity and management scale of fund products with management advisers

Products	Number	Size (billion yuan)	Proportion (number)	Proportion (size)
Asset management plans of securities companies and their subsidiaries	150	40.354	3.93%	4.75%
Special fund account and fund subsidiaries	1,274	284.823	33.41%	33.55%
Asset management plans of futures companies and their subsidiaries	353	34.038	9.26%	4.01%
Trust plans	1,959	460.114	51.38%	54.20%
Asset management plans of insurance companies and their subsidiaries	23	14.967	0.60%	1.76%
Bank wealth management products	5	0.227	0.13%	0.03%
Other	49	14.451	1.29%	1.70%
Total	3,813	848.974	100%	100%

Apart from the PSIF raised by the qualified fund managers, another significant portion of the PSIF funds available in the market are the funds issued by financial institutions such as securities companies and trust companies, which also act as the investment advisers of the funds. These funds are also known as "investment advisory funds." As shown in Figure 1-1-8, over 3,800 investment advisory funds were issued during the year 2017 with a total asset size of approximately RMB 850 billion.

The data shown points to a young and booming PSIF sector in China. Undoubtedly, it is one of the fastest growing sectors in China with ever-increasing levels of personal wealth and more experienced professionals leaving traditional financial institutions to start their own PSIF firm. However, the sector is not without challenges: there is a barrier of access to insurance funds and pension funds; limited ability to structure financial products for differentiation; and a lack of third-party professional service providers to enable efficient operation, among others.

With the introduction of new rules in the asset management industry in the first half of 2018, we expect the PSIF market will experience another round of opportunities and challenges as the regulator continues to control operational risk and promote the development of a healthy environment of a wider financial market. ●

To the point

- There is a slowing growth rate as the fund manager clean-up shows a more rational development under a benign and transparent environment for PSIF fund managers
- Shanghai becomes the number one choice for PSIF managers
- PSIF investment has become a more common investment channel for more high-net-worth populations
- Mixed (stocks and bonds) strategy overtook stocks-only as the most popular investment strategy of PSIF funds
- Self raising by fund managers is the most common sales channel of PSIFs in China
- The booming sector faces more opportunities and challenges with the implementation of new rules of the asset management industry





“Chinese-style” regulatory enforcement

Essence and trajectory

Natasha XIE

Partner
Jun He

In China’s immature capital markets, regulatory enforcement has typically oscillated between two extremes, which we can refer to as “weak regulation” and “strong regulation”, and this continues to be the case. Times of “weak regulation” have generally occurred due to an absence of regulatory measures and resources, while “strong regulation” has tended to be implemented in the form of “campaign-style law enforcement.” To understand the general direction in which regulatory enforcement has been moving requires insight into recent considerations of top-level policy formulation and of the general status of market development in China. ➤



Following the abnormal fluctuations of the stock market of 2015, it has now been three years since the China Security Regulatory Commission (the “CSRC”) took the lead with its regulatory actions to “enforce the law thoroughly, stringently and lawfully”. Despite some criticism of its “strong regulation”, the CSRC appears to have been able to withstand external pressure and has proceeded determinedly with its approach. Regardless of how the current round of “campaign-style” law enforcement is ultimately evaluated, regulators at least have provided a degree of transparency appropriate in the current internet era, and has responded to public opinion with the timely disclosure of their regulatory activities.

Successful investment, whether on the part of domestic or foreign investors, requires a thorough understanding of the ongoing changes in the regulatory environment. This article seeks to provide an analysis on the features and possible future trends of the “Chinese-style” regulatory enforcement by reference to the CSRC’s Bulletin on Inspection and Law Enforcement in the First Half of the Year (the “**Bulletin**”), published by the CSRC on its official website on 20 July 2018¹.

Successful investment, whether on the part of domestic or foreign investors, requires a thorough understanding of the ongoing changes in the regulatory environment.

1. Source: <https://deloitte/2LSUw6i>

01 The “Imperial Sword” of regulatory enforcement

The most recent round of regulatory enforcement has a clear policy orientation that is explicitly articulated in the Bulletin. In their stated objective relating to financial policy, the Party Central Committee and State Council have indicated the need to “enforce the law thoroughly, stringently and lawfully”. As one of the executive departments, it is the CSRC’s responsibility to ensure the strength and effectiveness of enforcement. On the basis of regulatory enforcement information published by the CSRC, 2017 witnessed record highs in the number and total value of administrative penalties and in the number of people banned from the market. In that same year, the CSRC undertook 312 investigative decisions and issued 237 administrative penalties and 25 market ban orders to 44 people.² This level of activity has continued through the first half of 2018,

with 307 investigations initiated and 108 cases newly put on file. The average case handling time in the first half of this year has been 133 days, a year-on-year reduction of 22 percent.³

It is worth noting that the Bulletin reaffirms that “enforcing the law thoroughly, stringently and lawfully” must be closely tied to “fighting the tough battle to prevent and resolve financial risks.” It is our observation that by using these specific terms, the regulator is declaring its position that, “enforcing the law thoroughly, stringently and lawfully” is the means while “fighting the tough battle to prevent and resolve financial risks” is the purpose, with the implication that the former must serve the latter. Regulators will be expected to follow this logic and should try to avert triggering or aggravating any threats to the financial system when imposing tough regulatory actions. ➤

On the basis of regulatory enforcement information published by the CSRC, 2017 witnessed record highs in the number and total value of administrative penalties and in the number of people banned from the market.

2. Source: <https://deloi.tt/2LSWmnl>

3. Source: <https://deloi.tt/2LSUw6i>

02 “Selective” law enforcement—constantly “focusing”

People familiar with China's financial markets are likely to understand that, with only limited regulatory resources, regulators need to be “selective” in how they go about carrying out enforcement actions. There are circumstances in which the decision about whether and how to take regulatory action could depend on a variety of factors, including: whether it involves a “key area” as defined by regulators; what type of signals the regulators wish to convey to the market; and whether their regulatory actions will produce immediate results. This goes some way to explain why the Bulletin intentionally outlines various key areas for law enforcement and proposes two guiding principles for actions, namely to “focus on key areas violations” and to “cautiously monitor any risks that could eventuate from illegal behaviors.”

According to the Bulletin, during the first half of 2018, there have been three areas of focus for law enforcement actions. The first has been the use of so called “financial innovation” tools to disrupt market order or to accumulate market risks, such as using funds raised illegally through wealth management products on peer-to-peer platforms to manipulate the market, or the use of over-the-counter options to carry out insider trading. The second is activity that causes a disruption to the order of the bond market and damages the interests of bondholders. The third is the use of privately raised funds to implement cross-border market manipulation under



cross-border Connect Programs. Some of the activities highlighted in the Bulletin follow on from recent bursts of illegal online fundraising, and have the intention of regulating new areas that might be targeted by violations, such as market manipulation related to Connect Programs. From this, we can conclude that the CSRC is keeping a watchful eye on the development of the market, in order to make its determinations about future key areas for regulatory enforcement. Hence, decisions about areas for enforcement in the second half of this year may shift depending on how the market evolves.

People familiar with China's financial markets are likely to understand that, with only limited regulatory resources, regulators need to be “selective” in how they go about carrying out enforcement actions.



03 Providing order to chaotic markets through campaign-style law enforcement

In China, there are three approaches typically used in campaign-style law enforcement: investigating and punishing multiple similar illegal activities at the same time; investigating and severely punishing any major infringement; and conducting deep and thorough investigations into “special cases”.

The Bulletin lists three potential sources of chaos in the market that the regulators are aiming to eliminate through the targeted use of their resources: serious breaches in the orderly dissemination of information to capital markets; repeatedly committing offences; and late disclosure of regular reports. The CSRC also names several major and special cases, in doing so reflecting the regulator’s determination to take a tough line in those cases. ●

To the point:

- This round of “strong regulation” activity takes an approach that is distinctively Chinese, and the market should pay close attention to its further development.
- By continuing to review regulatory policies and to monitor the enforcement of relevant laws, we hope that foreign investors will ultimately be able to better understand the inherent logic of China’s capital market supervision and enforcement actions, putting them in a position where they are able to adapt to the specific characteristics of the Chinese market.



Dr. Zhang Qi—Deputy CEO of Tsinghua Tongfang Financial Holdings

Dr. Zhang Qi currently is the Deputy CEO of Tsinghua Tongfang Financial Holdings. Dr. Zhang is specialized in launching industry funds, which is one practice to integrate finance and industry. Before joining Tsinghua Tongfang Financial Holdings, Dr. Zhang was the Director of Investor Education and International Affairs Department at AMAC, and has served in CSRC for a decade. As an experienced expert who has been working in the financial sector for over two decades, Dr. Zhang has a profound understanding of investment and regulatory activities of capital markets.

Dr. Zhang Qi currently holds a PhD in Microeconomics and Economics from Huazhong University of Science and Technology. She also received her MBA from Tsinghua University. Between August 2009 and June 2010, she was a visiting scholar at South California University in the US.

Where finance meets industry

*Interview with **Dr. Zhang Qi**, the Deputy CEO of Tsinghua Tongfang Financial Holdings, for an understanding and outlook of Tsinghua Tongfang Financial Holdings as well as the ESG agenda in China.*

Supported by the scientific research strength and the elite talent pool of one of the best universities in China, Tsinghua Tongfang Co., Ltd. (Tongfang) was founded by Tsinghua University and was listed on the Shanghai Stock Exchange (Stock code: 600100) in June 1997. Over the last two decades, Tongfang adheres to the combination of production, learning, and research; positions itself as a comprehensive incubator of the science and technology industries; and commits to the transformation and industrialization of China's high-tech achievements.

Tongfang promotes the development of industrial clusters that are closely linked to the national economy and people's livelihoods, with its operations focused on the "eight industries and areas" with subsidiaries spanning public security, cloud computing and big data, electronic equipment and commercial consumption, life and health, energy and resource conservation, environmental protection, lighting and illumination. As of the end of 2016, the total assets of Tongfang exceeded RMB57 billion, with an annual operating income of nearly RMB30 billion.

Tsinghua Tongfang Financial Holdings (TFFH) was established in May 1999 as a wholly owned subsidiary of Tongfang with a registered capital of RMB4.47 billion. TFFH is the only financial asset and investment management platform under Tongfang. TFFH controls a number of licensed financial institutions. On a combined basis, the assets under management are approximately RMB40 billion.

Recently, Deloitte had the honor to interview Dr. Zhang Qi, the Deputy CEO of Tsinghua Tongfang Financial Holdings, to talk about her understanding and outlook of TFFH as well as the ESG agenda in China. [➤](#)

Under the model of "one institution, one park, and one fund," we work with local governments (provincial or municipal) to establish local industrial funds and help strengthen the development of specific industries.

Deloitte: Dr. Zhang, as the Deputy CEO of Tsinghua Tongfang Financial Holdings, could you please share your understanding of the business model of Tsinghua Tongfang and Tsinghua Tongfang Financial Holdings?

Dr. Zhang Qi: Tsinghua Tongfang was founded by Tsinghua University about 20 years ago. Tongfang adheres to the strategy on "the integration of industry and finance" to support our contribution in eight focused industries and areas such as clean energy, health and elderly care. Tsinghua Tongfang Financial Holdings is the sole financial and investment platform wholly owned by Tsinghua Tongfang. TFFH strives to leverage our resources to facilitate a variety of structured investment and financing solutions. These support the transformation of scientific and technological achievements as well as the industrial consolidation and the integration of industrial chains, with the ultimate goal to support the development of Tongfang on a wider basis.

In terms of the operations of TFFH, we have three main business lines. The first one is the asset management business where we hold interests in other well-known investment institutions. The second business line is what we call the "license business," where we have

substantial control or act as the single largest shareholder in licensed financial institutions including Aegon-THTF Life Insurance Company, Chongqing Trust, Guodu Securities, Yimin Asset Management Company, and Bank of Three Gorges. The third business line, which has always been our main drive, is that we support the development of Tsinghua Tongfang, especially for its outbound Merge & Acquisition activities.

Deloitte: You talked about the strategy of integrating industry and finance. Given the current social environment and economic conditions, what are the opportunities for you in this perspective?

Dr. Zhang Qi: Our strategy of "integration of industry and finance" is supported by the model of "one institution, one park, and one fund," where "one institution" is a research center that provides academic and scientific support; "one park" is the R&D center for technological experiments and production; and "one fund" is the government-backed industrial fund that provides financial support to the operations of the model. In China, the gaps existing in and between different cities, regions, and rural areas bring different layers of demands with respect to the level of development under their specific

regional characteristics. For example, in rural areas, we understand that the basic infrastructure development and basic health care are priorities for development, whereas for cities, the competition and establishment of cutting-edge technological companies and facilities with high-quality elderly care are more in-demand. We have a rich experience in matching financial needs with the demands from various industries in different areas and therefore have been actively exploring opportunities for collaboration with different industrial funds.

Under the model of "one institution, one park, and one fund," we work with local governments (provincial or municipal) to establish local industrial funds and help strengthen the development of specific industries. This strategy also aligns with our mission "to serve the country with industries." We already have some successful cases, such as the great cooperation with the investment platform of Shandong province to launch the Shandong Green Development Fund. We also have a number of other opportunities under discussion and I am confident in more integration of industry and finance in the future.

This strategy also aligns with our mission "to serve the country with industries."

Deloitte: What is your view on the current ESG investment trend, and what do you see happening in the future?

Dr. Zhang Qi: In China, all State-Owned Enterprises (SOEs) had published their ESG reports according to the instructions of the State-Owned Assets Supervision and Administration Commission of the State Council. The Stock Exchanges in China had published their respective ESG reporting guidelines for their listed companies. It has also become a hot topic in the private sector; we can see a lot of discussions going on with the regulators and other investment management companies.

I personally have been promoting the concept of ESG to the asset management industry in China for more than a decade. I think ESG has the most promising and strategic aspects of investment management sector in China. I believe that the ESG investment should not just be a trendy concept, but more importantly, it is instilled in every single step we take to carry out the plans and strategies in the development of the financial sector.

TFFH is actively involved in ESG practices. We are launching the series I of the Shandong Green Development Fund with a target size of RMB1.7billion. This fund focuses investments in projects in fields of new energy development, clean energy, and energy saving, which aims to help form a new engine to promote the local economy. On the other hand, TFFH is one of the 77 sponsors of Xiangmi Lake Consensus, which is initiated under the global ESG consensus, and aims to create the ESG ecosystem and explore the opportunities in poverty alleviation and development, health care, safety education, environmental energy and social issues.

Deloitte: What is your future investment schema?

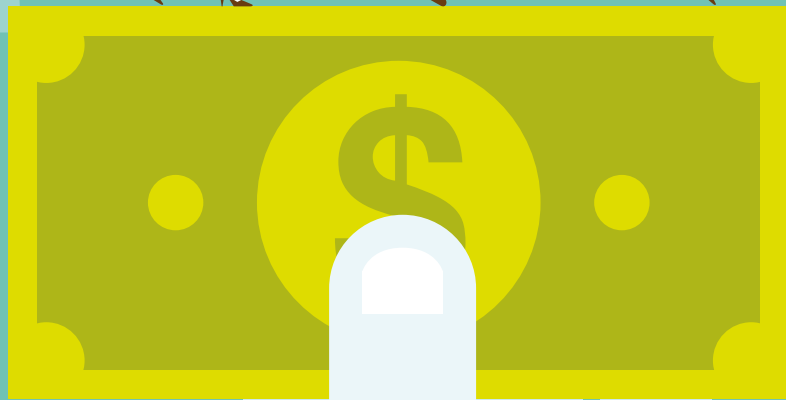
Dr. Zhang Qi: In the next 50 years, the development model of the urbanization process in China will undergo tremendous changes. The cooperation between cities before will be transformed to collaborations between urban groups, and a positive cycle will be generated between the cities and industries. The smart industry capital will guide the upgrade of the city and the formation of urban groups, and in return, these groups ensure better development of the industries with scales of economy. Among all the forms of capital, we believe the model of Fund of Funds (FOF) has a great potential in this process.

FOF is an efficient model that covers the entire operating chain of an industry, facilitating technology incubation and deployment but also offers significant diversification of risks by selecting the best fund managers in the market. During

our visits to many local governments, they express great interest in setting up funds in the form of FOF, as it is a good way to leverage their own capital to the largest extent. Therefore, I think FOF will continue to be our priority structure in setting up new funds, especially in the silver and green industries.

As we are an investment platform backed by a high-tech company, we place great importance on the influence of digitalization in both the investment selection process and post-investment process. The current focus of the market is more on the investment side and on the secondary security market where data can be more easily quantified. We are now testing an internally developed post-investment management system of our businesses in the primary market to ensure the rigid measures and efficient management of investment projects and to maximize the possible return of our investment.

Among all the forms of capital, we believe the model of Fund of Funds (FOF) has a great potential in this process.



Equity bridge financing

Reaping the benefits of liquidity and flexibility

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In the sophisticated world of private equity, what is the role of equity bridge financing, and how can it improve returns to investors? Despite some recent claims that such financing can be regarded as a “trick”, in reality there is a great deal to commend equity bridge financing as a key tool for investors to smooth the process of private equity investing to the benefit of both investors and the market as a whole. >

One of the key features of EBFs is that they allow capital calls to be delayed, thereby providing greater flexibility to the fund's management company to control profitability.

How does such financing work? Equity bridge facilities (EBF), also known as "subscription line facilities" or "capital call facilities", are short-term loans leveraged on the limited partners' commitments of infrastructure, private equity, real estate or other funds, and usually take the form of revolving facilities.

These facilities are granted at fund level (subject to applicable legal and regulatory limitations) or through a special purpose finance vehicle held by the fund with an accompanying guarantee from the fund. In this short note, we summarize a number of key features of EBFs. Bridges continue to be built between private equity firms and providers of subscription lines for financing acquisitions and for add-on acquisitions. Some subscription lines are also now used as a structuring tool for the financing of an add-on acquisition or for small to mid cap PE/VC acquisitions. The current themes are very much the same over the last years, but with different variations depending on the jurisdictions involved in the cross-border financing and the size of the acquisition.

Benefits to fund managers

One of the key features of EBFs is that they allow capital calls to be delayed, thereby providing greater flexibility to the fund's management company to control profitability. EBFs are used by the fund to



finance projects, or if necessary to pay any costs incurred upon a failed acquisition (e.g., advisory fees). The delay to call capital from investors improves the IRR at exit due to the costs of the EBF being less than the rate anticipated by investors. For example, an EBF of one year may reduce the amount of time between capital calls and the sale of an asset from five years to four years, thereby reducing the time denomination employed in calculating and improving the IRR.

If we take a recent example, the CFO of a recent major European buyout firm performed an analysis on how the IRR on their funds could have been improved if they had used such facilities. **The analysis showed a 5 percent improvement in the IRR from improved timing around investments acquisition and disposals, and a 2 percent improvement in the IRR just from the timing of the fund manager's own fees to the fund.**

A second notable feature is that the due diligence conducted by lenders is generally limited to the powers of the manager or general partner under the fund's documents, any side letters agreed with investors, and subscription agreements. The core of the due diligence is conducted on the commitment period, any limits applied to borrowings and the security and, if applicable, the guarantee that may be granted by the fund, the rights of the limited partners to transfer their commitments to third parties and excuse rights—as the main security is the right of the lender to call undrawn commitments in accordance with the fund's documents as well as any (future or present) claims, receivables, rights or benefits of the fund,

acting through its manager or general partner arising out of or in connection with the fund's documents. Such security varies from one jurisdiction to the next. For example, for English borrowers, power of attorney is granted by the general partner to the lender. For Luxembourg borrowers, an assignment by way of security is granted by the manager or general partner and the fund to the lender, together with a pledge over the fund's bank account and an assignment of all undrawn commitments of its investors with an express right for the lender to request direct payment of any sum due under the EBF from the investors of a French fund.

If we look at the results of such financing, continuing with the example of France, where one of the banks introduced equity

bridge financing for private equity funds three years ago, it is clear that the solution has become increasingly popular—due to the growing private equity market, as well as the fact that it meets the needs of fund managers and end investors by staggering and reducing the number of calls for funds. Over 40 transactions were concluded in the first three years. It has noted that, beyond using EBFs to improve a fund's IRR, such financing enables management companies to be reactive when negotiating investments and provides the fund's investors with greater visibility regarding future calls for funds. **Furthermore, it has been noted that EBFs do not create leverage since they do not increase the fund's investment capacity.** ➔

A second notable feature is that the due diligence conducted by lenders is generally limited to the powers of the manager or general partner under the fund's documents, any side letters agreed with investors, and subscription agreements.

The economic contribution of EBFs

In practice, there is a significant variation in loan size, ranging from €50m to over €500m. Lenders generally compute the maximum potential borrowing amount as a percentage of the commitments of “qualifying investors” (e.g., 80 percent of AAA-rated investors’ commitments) subject to a “haircut” (e.g., 20 percent typically applied to those investors with a participation greater than 20 percent of total commitments). Cases where an investor may be excused or transfer its commitment are therefore crucial to the lender. Qualifying investors include financial institutions, public or private pension plans, investors with assets valued greater than an amount determined by the lender, investors meeting rating agency requirements (as set out in the facility agreement), and such other investors as the lender may determine in its discretion given that, from the lender’s perspective, the quality of the investor base should remain unchanged for the duration of the EBF. The costs of borrowing depend on the fund’s size and investors’ level of risk (the main trends in Europe are stable over the last two years, showing a margin between 1.85 to 2.70 percent for EBFs granted for a period of one to three years), a commitment fee ranging between 0.25 and 0.50 percent, and an arrangement fee between 0.25 and 0.75 percent.

In addition:

01. Capital calls are usually sent to investors 10 to 20 days prior to the repayment date of the facility
02. The margin is made by reference to the interest period, i.e., it may be one, two or three months’ interest, or any other such period as agreed with the lender. The margin is payable at the end of the interest period, or alternatively, is capitalized
03. Borrowers generally prefer an uncommitted facility rather than a committed facility to limit borrowing costs; and



04. Financial covenants are frequently set with a debt-to-qualifying-investor-undrawn-commitment ratio of 1:1.1/1.5, and a debt-to-aggregated-NAV-and-qualifying-investor-undrawn-commitment ratio of 1:2.0/2.5, with the facility to be covered at all times by 1.5x the unfunded commitments of the fund’s investors

The figures are sufficiently compelling that key players across the private equity market are now known to be using such financing on a regular basis, with executives at firms including Blackstone, Carlyle, and KKR reported as saying that their funds have begun relying on borrowed money at the beginning of their lives to varying degrees¹. In practice, it is very common to negotiate an EBF to be signed at the first closing of the fund.

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1. <https://deloitte/2M9KBNN>

Specific representations and undertakings

Borrowers or guarantors will represent that the “excused” undrawn commitments of the investors do not exceed the total undrawn commitments of investors, and that there are no other creditors of the fund or borrower SPV other than the manager. Other specific covenants include:

01. The manager's or fund's obligation to call a minimum amount from the fund's investors on an agreed frequency
02. The manager's or fund's obligation to provide information on the investors' commitments (e.g., failure to pay, exclusion events, key man events, excused investors)
03. Subject to the security package, the manager's or fund's obligation to provide all information necessary to allow the lender to issue drawdown notices (e.g., amount of undrawn commitments by the investor, contact details, copies of applications)
04. No distribution by the fund while amounts are outstanding under the facility or in the case of a default on payment
05. No borrowing during a key man event and where a change of manager control has occurred
06. A negative pledge over the undrawn commitments of the investors;
07. An obligation to pay the undrawn commitments on a pledged bank account; and
08. an obligation to pursue defaulting investors and to request payment of the shortfall to the other non-defaulting investors

Specific events of default

As with the representations and warranties, events of default will depend on the type of fund, but generally include:

01. The removal of the manager upon its insolvency;
02. The termination of the fund;
03. A cancellation threshold (usually 5 to 20 percent of undrawn commitments being cancelled);
04. An insolvency threshold (usually 5 to 20 percent of investors becoming insolvent);
05. A defaulting investor threshold (where investors fail to comply with their obligations to fund their undrawn commitments)
06. A transfer threshold (where an investor's undrawn commitments are transferred to a third party after the execution of the facility agreement); and
07. An excused investor threshold (where investors are excused from complying with a drawdown notice)

Striking the right balance

While equity bridge financing has much to commend it, it has increasingly become an important discussion point between sponsors and limited partners. Given the extent of the use of EBFs by most funds,

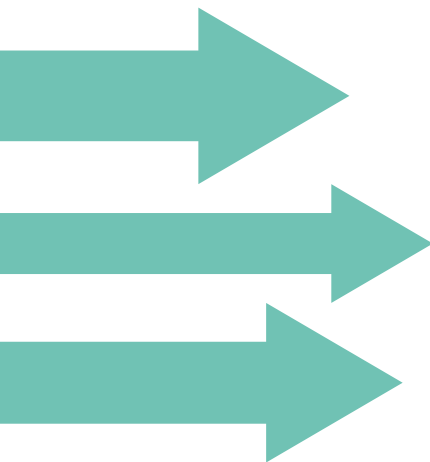
investors are asking more questions about the details of these arrangements and are starting to request specific reporting, projections and terms in side letters where, for example, certain financings are restricted or information on investors is limited, thus changing the fund documentation to deal with their concerns. In June 2017, the Institutional Limited Partner Association (ILPA) issued a publication to its members that included nine points of guidance. The ILPA also outlined some concerns that they have in relation to lines of credit, such as the difficulty in comparing the performance of funds that use these facilities with those that do not (as the use of a credit line can increase a fund's IRR), the expenses incurred as a result of a credit line (both upfront costs and ongoing interest), how longer-term facilities may cause UBTI issues for U.S. tax-exempt investors, as well as the liquidity risk to investors if a market event triggered a large number of capital calls from managers to repay the outstanding facilities. This being said, there is a general consensus that subscription lines take various forms, adapt quickly to the market and are useful, if only for providing flexible and creative financing to GPs enabling them to react quickly to market opportunities and maximize returns. ➔



Looking at the impact of the ILPA guidelines, some legal advisers have identified two major trends in negotiations between fund managers and investors on the use of such funding facilities². The first is greater disclosure, with fund managers increasingly providing investors with two IRR calculations, one reflecting the usage of the relevant fund's subscription facility, and the other backing this usage out. They have also identified that there is also more disclosure of the costs associated with a fund's subscription line, in particular interest and fee rates, and of mandatory prepayment triggers and events of default, especially any events outside a fund's control that could trigger early repayment. This is not the case for the majority of limited partners. In a competitive market, nobody disagrees that investment funds need access to financing to support their operating costs and help grow their investments. While the conditions of the financing are considered by limited partners, they do not generally take any action when negotiating the fund documents that would somewhat restrict access to that financing, which benefits the fund as a whole; the trend is generally to request transparency on the calculation of the IRR.

The length of time that advances under subscription facilities remain outstanding is an issue. It is generally accepted that the ILPA's guidelines were initially designed to promote a dialog between sponsors and limited partners. They are not a list of points to be included in the constitutive documents or side letter of every fund. More generally, fund managers are likely to continue to provide investors with greater disclosure about the terms and use of these facilities, including, increasingly, by providing calculations of both a levered and an unlevered IRR.

It should also be noted that limited partners, in some cases, benefit themselves from some form of financing in their favor and in respect of their investment in a fund. There is in most cases, an alignment of interests where the sponsor and limited partners can enjoy the benefits of a subscription line facility. Limited partners want to see their commitments being put to use and do not typically expect to fund investments 12 or 18 months after they have been made (once the subscription line can no longer be used for that investment).



More generally, fund managers are likely to continue to provide investors with greater disclosure about the terms and use of these facilities, including, increasingly, by providing calculations of both a levered and an unlevered IRR.

2. <https://deloit.tt/2vr19ah>



Conclusion

A detailed analysis of the investment structure and the investor is always critical in determining the key terms of the EBF to be granted to a fund, especially in light of the potential impact on the third-party lender's capital costs.

In addition, due diligence around fund terms and the investors that secure the credit is necessary to assess whether an EBF is a preferred option for private fund managers. ●

To the point:

- Equity bridge financing is an acceptable means of improving both IRR and liquidity for investors in closed-ended funds
- Given evolving investor standards and requirements, the use of EBFs and impact on IRR and returns needs to be transparently and fully disclosed
- The improvement in returns to investors from the use of EBFs to improve cash flow timing around investments and fees outweighs the cost of the facilities
- EBFs also enable fund managers access to deploy capital and move quickly when needed on pre-emptive deals that increase returns to investors



The EU Benchmark Regulation: Users be cautious

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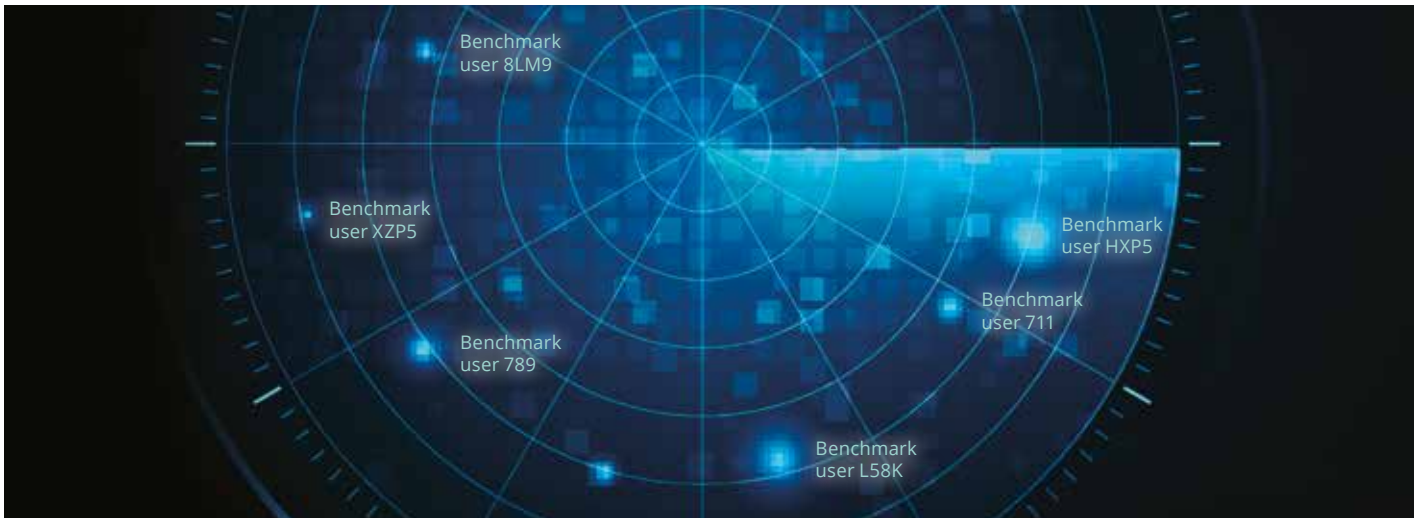
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The EU Benchmark Regulation (BMR) came into effect on 1 January 2018, but many benchmark users have not fully assimilated the impact of the BMR on their business. MiFID II may have been a distraction for some users, while others may have mistakenly assumed they had until 31 December 2019 to comply with this new regulation. In addition, other firms may have concluded that they would not be impacted by the BMR, simply because they are not benchmark administrators¹. Users should not be complacent; unlike the IOSCO Principles for Financial Benchmarks, the BMR also impacts benchmark users. ➤

1. If you are a benchmark administrator, you may want to read our previous Deloitte blogpost on the BMR: EU Benchmark Regulation: Are you ready for implementation?



Am I a benchmark user?

To determine whether you are a benchmark user, ask yourself the following:

01. Do I manage financial products/ contracts ("products") that reference indices?
02. Are these products registered for distribution within the European Economic Area (EEA)?

If you answered yes to both questions, you may be a benchmark user. Even if your firm is located in the EEA but only offers products outside of the EEA, you may still be impacted and should continue reading.

However, there is still a chance that you are not impacted. Only certain products come under the scope of the BMR. The list of products essentially follows the definition contained in MiFID II. The most common include UCITS², AIFs³, structured products, derivatives, and certain credit agreements.

In combination with the distribution and the type of product, the use of the index will then determine whether you are impacted by the BMR. If you use an index to:

01. Determine the amount payable under a financial instrument or contract, or the value of a financial instrument
02. Measure the performance of an investment fund for the purpose of tracking the return, defining the asset allocation, or computing the performance fees

This means you are a benchmark user and you have to comply with various requirements on contingency measures, control framework enhancements, and disclosures.

Accordingly, the act of simply holding products that reference an index, and, in the case of investment funds, referencing a benchmark for performance comparison or marketing purposes (e.g., factsheet), does not constitute benchmark usage.

Only certain products come under the scope of the BMR. The list of products essentially follows the definition contained in MiFID II.

2. Undertakings for Collective Investments in Transferable Securities

3. Alternative Investment Funds

I am a benchmark user. What do I need to do?

1. Benchmark Compliance

Benchmark users must ensure that they only use benchmarks that are provided by benchmark administrators included in the ESMA Benchmarks Register⁴, or that benefit from the transitional provisions until 31 December 2019.


How can you achieve compliance?

01. Assess all your products to determine which of them come under the scope of the BMR.

- 02. For in-scope products, determine the index providers and assess whether they are included in the ESMA Benchmarks Register or benefit from the transitional provision. Often, index providers publish information on their compliance status or intention to become compliant on their website. If you have any doubts, please contact your index provider.
- 03. Establish controls around the use of benchmarks to ensure that only benchmarks provided by BMR-compliant administrators are used. ➔

Benchmark users must ensure that they only use benchmarks that are provided by benchmark administrators included in the ESMA Benchmarks Register.

Illustration 1: How to determine whether an index provider benefits from the transitional provisions under the BMR

	Benchmark Administrator		
	Already provided benchmarks on or before 30 June 2016	Started providing benchmarks after 30 June 2016	Authorization/Registration/Endorsement refused or revoked
 Benchmark			
Existing on or before 1 January 2018	<p>Yes</p> <p>transitional provisions apply. Indices can be used as benchmark for BMR in-scope products</p>	<p>Yes</p> <p>transitional provisions apply. Indices can be used as benchmark for BMR in-scope products</p>	<p>No</p> <p>indices must not be used as benchmark for BMR in-scope products</p>
Launched after 1 January 2018	<p>Yes</p> <p>transitional provisions apply. Indices can be used as benchmark for BMR in-scope products</p>	<p>No</p> <p>indices must not be used as benchmark for BMR in-scope products</p>	<p>No</p> <p>indices must not be used as benchmark for BMR in-scope products</p>

4. The ESMA Benchmarks Register can be found on <https://www.esma.europa.eu/benchmarks-register>.

2. Contingency measures

In essence, benchmark users are required to implement the following contingency measures:

01. Benchmark users must produce and maintain robust written plans setting out the actions they would take if the benchmark materially changes or ceases to be provided
02. If feasible and appropriate, benchmark users must also select at least one alternative benchmark as a substitute and provide a justification for the selection

How can you achieve compliance?

01. Establish a written benchmark contingency plan, which must be provided to a regulator upon request. It is not an option to rely on the benchmark administrator's contingency measures
02. Define alternative benchmarks and ensure that you have received authorization from the responsible product owners in your firm. It is recommended that alternative benchmarks are selected from BMR compliant administrators that are different from the provider of the original benchmark
03. Establish a process to ensure that an alternative benchmark is defined whenever a new product is launched or a benchmark is changed
04. Enhance your UCITS and AIF prospectuses with a disclosure on contingency measures. (Refer to section 3 for timeline)
05. Establish controls to periodically review the suitability and BMR-compliance of the selected alternative benchmarks

If a benchmark administrator terminates a benchmark or changes the methodology, it is recommended to reassess the suitability of the alternative benchmark and, if necessary, select a new one. In general, you do not need to have a license for your alternative benchmarks, as long as they are not used.

3. Benchmark disclosure

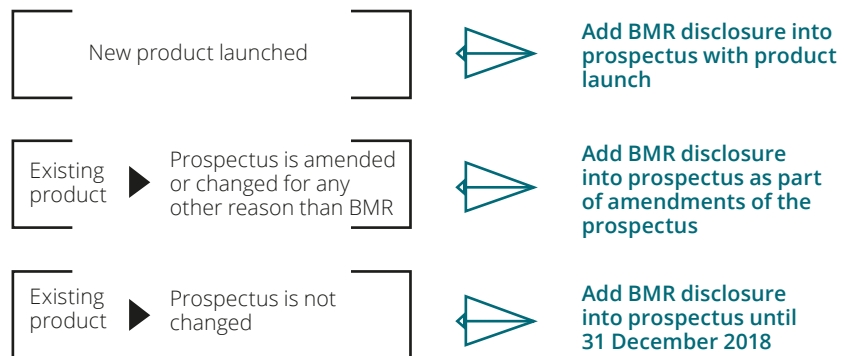
Benchmark users must add a disclosure to the relevant product prospectuses stating that the benchmark is provided by an administrator included in the ESMA Benchmarks Register or benefits from the transitional provisions. However, benchmark users are not required to publish benchmarks in their prospectuses that have not been disclosed previously. The following documents need to be updated within the set timeline:

01. Until 1 January 2018: prospectuses of securities that are offered to the public or admitted to trading⁵
02. At first occasion or latest until 31 December 2018: UCITS prospectuses⁶

Interestingly (and inconsistently), the BMR only requires that disclosures be added to UCITS prospectuses, but not to AIFs. Moreover, KIIDs, PRIIPS, or any marketing material (e.g., fund factsheets or client reporting) are not affected.

To achieve compliance, you should update your product prospectuses with this disclosure.

Illustration 2: Applicable timeline for updating fund prospectuses



5. Pursuant to Directive 2003/71/EC
6. Pursuant to Directive 2009/65/EC

7. Multilateral Trading Facility as defined under MiFID II
8. Organised Trading Facility as defined under MiFID II

4. Notification

Benchmark users that qualify as market operators in regulated markets or that are operating an MTF⁷ or OTF⁸ must include the name of the referenced benchmark and its administrator in their notification to the competent authority of the trading venue of any financial instrument for which a request for admission to trading is made.

When should I be compliant?

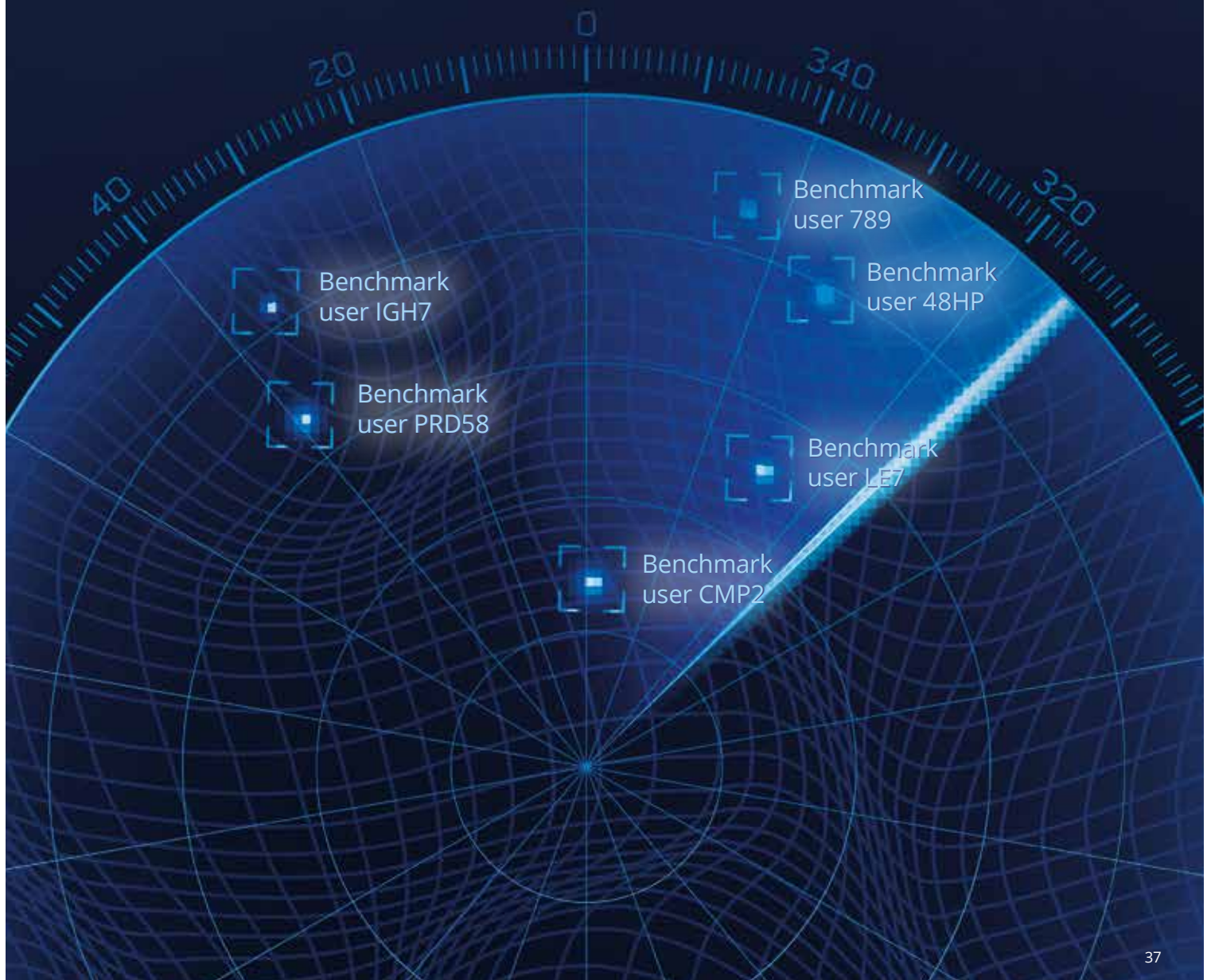
Benchmark users must comply with the BMR since 1 January 2018.

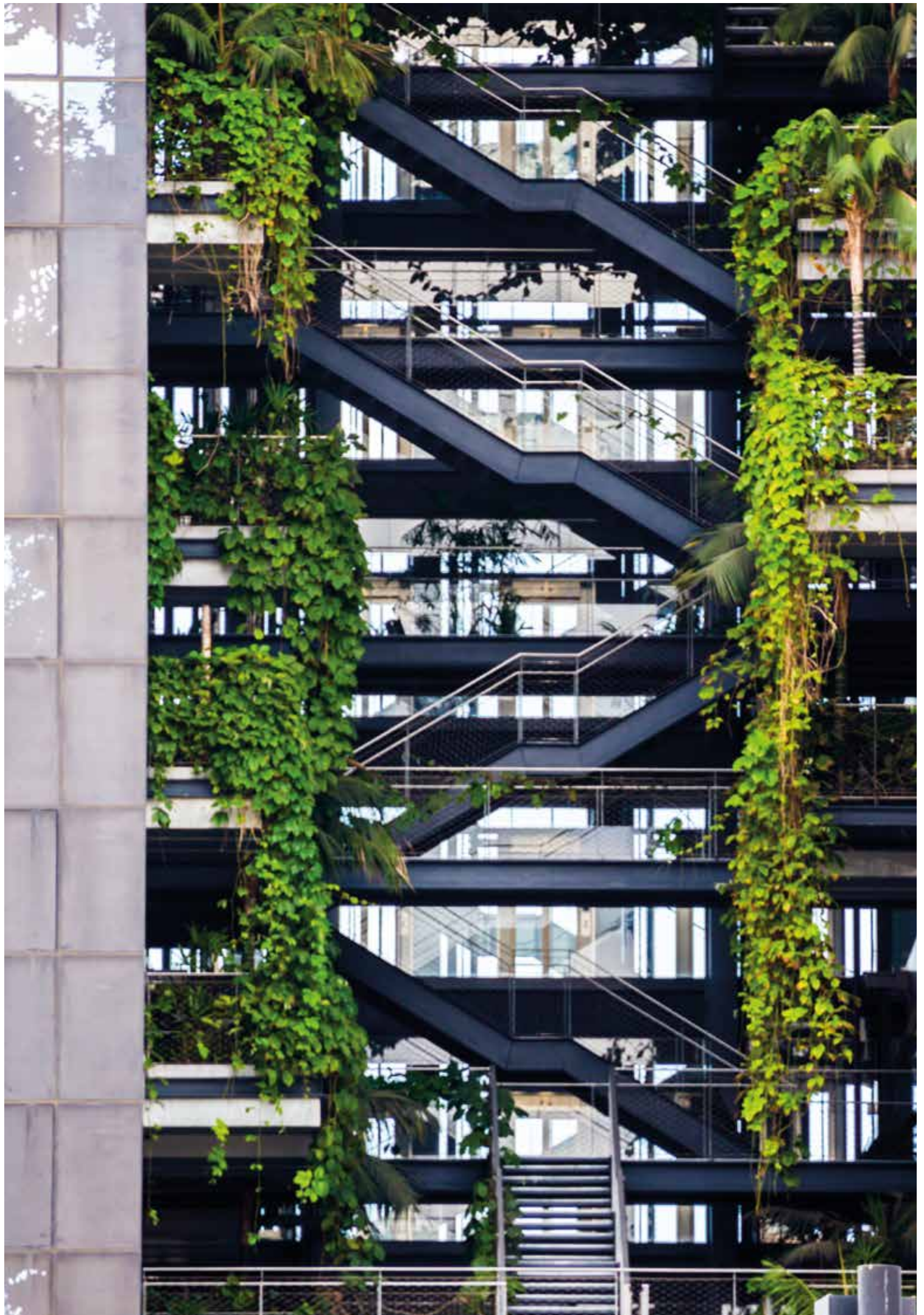
Any last words?

You may have determined that you are neither a benchmark administrator nor a user. We still recommend checking whether you are a data contributor or an outsourcing partner to a benchmark

administrator, as this would trigger additional requirements.

Last but not least, the BMR will not be the last regulation on financial benchmarks. The Monetary Authority of Singapore is also expected to introduce regulation on financial indices. A first consultation paper was already published in June 2013. ●





Green finance moving ahead to sustainable

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While the EU Commission is accustomed to big regulatory plans, generally synchronized with the arrival of a new team at the top of the institution, this time the green finance or sustainable finance agenda is marking a leap forward in terms of green policies notably by being released at the end of a EU Commission Cycle and with an agenda likely to go much beyond the current and next EU Commission.

From early 2018, several signs indicated that the EU was preparing something on the back of the Paris COP 21 from 2016 and probably in response to the United States' change of direction. In practice, in mid-March 2018 the EU Commission launched its Sustainable agenda for finance at a large conference with the objective to transform the financial industry from inside out in order to make it "Green aware". [➤](#)

Based on this work, the EU Commission has developed the so-called action plan, financing sustainable growth, which was presented in March 2018.

To reach this objective, the EU Commission mandated in 2016 a wide group of high-level experts on sustainable finance (the “High-Level Expert Group—HLEG) to define the priority areas and propose an action plan. This was a way to secure the commitment of the industry and other stakeholders on a number of objectives.

There are two main ideas:

- The strategy is sustained by a powerful force for a long term
- There will be a switch from optional to mandatory approach

The EU Commission plan

The HLEG published its final report in January 2018, listing eight key recommendations and related industry-specific recommendations. Based on this work, the EU Commission has developed the so-called action plan, financing sustainable growth, which was presented in March 2018.

This plan is outlined in the ten initiatives below:

- Establishing an EU classification system for sustainability activities
- Creating standards and labels for green financial products
- Fostering investment in sustainable projects
- Incorporating sustainability when providing investment advice
- Developing sustainability benchmarks
- Better integrating sustainability in ratings and research
- Clarifying institutional investors and asset managers' duties
- Incorporating sustainability in prudential requirements
- Strengthening sustainability disclosure and accounting rule-making
- Fostering sustainable corporate governance and attenuating short-termism in capital markets



The EU financial industry, likely as with many other industries, has taken this green initiative seriously but not yet made it a concrete regulatory requirement.



Interestingly, four EU Commissioners attended the presentation of the action plan, showing a strong commitment from various angles of the institution. In May 2018, the Commission presented a package of measures as a follow-up to its action plan on financing sustainable growth. The package focuses on four core axis:

- Define a unified EU environmentally-sustainable classification system (“taxonomy”)—the objective being to provide economic actors and investors with clarity on which activities are considered sustainable in order to inform their investment decisions. This would help to ensure that investment strategies are oriented towards economic activities that are genuinely contributing to the achievement of environmental objectives, while also complying with minimum social and governance standards
- Introduce consistency and clarity on how to integrate ESG considerations into the investment decision-making process and how to report on them—this should ensure that financial market participants receiving a mandate from their clients or beneficiaries to take investment decisions on their behalf would integrate ESG considerations into their internal processes and inform their clients in this respect.
- Create low-carbon and positive-carbon benchmarks—the proposal sets out two new categories of benchmarks: a “low-carbon benchmark” and the “positive carbon impact benchmark”. In a low-carbon benchmark, underlying assets would be selected with the aim of reducing the carbon emissions of the index portfolio when compared to the parent index; whereas a positive carbon impact index only comprises components whose emissions savings exceed carbon emissions.
- Include ESG consideration in suitability tests—the Commission is planning major changes by incorporating ESG criteria into the current MiFID II suitability process. MiFID service providers would have to collect a client’s ESG preferences and subsequently provide suitable ESG products.

This means that the EU action plan is materializing quickly and will be already partly applicable in approximately two years. It is not an “unveiling”, but very close. The EU financial industry, likely as with many other industries, has taken this green initiative seriously but not yet made it a concrete regulatory requirement. However, the MIFID II amendment marks the first true awareness moment for many. ➔

Focus on MiFID II & benchmark— lack of agreed taxonomy

A practical case of direct application of the EU Green Agenda can be seen in the introduction of change proposals to the MiFID II Regulation in the suitability model and client profiling sections.

Indeed, with the view to push green-conscious financial products and to foster new private investment flows, the EU Commission proposes to oblige investment firms to integrate investors' Environmental, Social and Governance (ESG) preferences into the suitability framework. This means that investment firms will have to collect the ESG preferences of their clients through the investor profiling questionnaire and take them into account in the suitability assessment.

The final recommendations to the client reflect both the financial objectives and, where relevant, the ESG preferences of that client. Investment firms providing investment advice and portfolio management should consider each client's individual ESG preferences on a case-by-case basis.

Moreover, investment firms should disclose, where relevant, information on the ESG preferences of each financial product offered to clients before providing investment services.

Investment firms should also explain to clients how their ESG preferences for each financial instrument are taken into consideration in the selection process used by those firms to recommend financial products.

All these modifications are laid out, as expected, under an amendment to the Delegated Regulation 2017/565 on organizational requirements, which in practice might shortcut the classic regulatory process, leading to a much earlier application—even with an 18-month-transition period.



Interestingly, the EU Commission proposed amendments to the Directive 2016/97 established for insurance intermediaries and insurance undertakings distributing insurance-based investment products (IDD) to act in accordance with the best interests of the client. The Delegated Regulation (EU) 2017/2359 required them to define proposals to clients taking into account information on investment objectives of the client that should include information regarding the risk tolerance, the length of time to hold the investment, and on the risk profile and the purposes of the investment but also ESG preferences.

The proposal, released on 24 May, will require insurance intermediaries and insurance undertakings to recommend the most suitable products to their clients or potential clients. Those operators will have to introduce questions in the suitability assessment that help identify the client's ESG investment objectives. In practice, the final recommendations to the client should reflect both their financial and, where relevant, ESG preferences.

Similarly to the MiFID II amendments, there will be an 18-month transition period to adapt to the changes.

The changes are also introduced via amendments to a delegated act, which should lead to a faster adoption process.

The combination of both proposals implies at least two major consequences. The first being that green Finance is here to stay and will gradually spread across all activities including finance, something that we consider a positive development in the long run. Then, more pragmatically, the EU Commission proposal implies a review of the products proposed by asset managers to clients. Indeed, this will not only impact the distribution side, but also the source (i.e., the manufacturing side).

Moving Forward

In fact, from the relatively modest changes brought into MiFID or IDD regulations, a complete taxonomy of "green or sustainable finance" terminology should be established, spreading to asset



management both on the fund side and on the structuring side. This terminology will notably be impactful through the need to inform clients via the KIID/KID, or to supply investment firms and insurances with information about the products, thereby helping build knowledge and awareness. This would, in a post-MiFID II/IDD world, be a nice way to differentiate oneself from the competition by proposing green products.

In the long- term, it is likely that the EU Commission will have no choice but follow the logical path of—it might be good to have sustainable products, but it would be even better if these products are produced by sustainable entities. This would lead to the application of sustainable principles not only for products to meet investor's demands but also to ensure that, at organization level, the organization is geared towards sustainability. ●

In fact, from the relatively modest changes brought into MiFID or IDD regulations, a complete taxonomy of “green or sustainable finance” terminology should be established, spreading to asset management both on the fund side and on the structuring side.

To the point:

- While the recent post-crisis regulatory agenda has brought about many changes, mostly through more stringent regulations, this green initiative that follows a global agenda aims at having a lasting impact on finance and the economy at large
- In Luxembourg, it is worth noting that besides the FinTech trend, another booming trend is green and sustainable finance. The Luxembourg Stock Exchange is attracting a lot of attention with its Green Stock Exchange, as well as LuxFlag with its labeling initiative, means that MiFID II and accompanying proposals in insurance, fund, benchmark, and future prudential regulation might adequately complete and strengthen the competitiveness of the Financial Center as a green and sustainable market
- From now on, it is essential to adapt and gear each firm to consider the green and sustainable elements within its strategy. It is also interesting to note that this green evolution is increasingly supported by the general public; culture is changing, and thus investors and clients are changing, which by itself is leading to a long-term need for a sustainable strategy to support greener products for the good of everyone.

Regulation as new standalone business line

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Almost five years ago, Deloitte Luxembourg launched a regulatory watch service called Kaleidoscope RegWatch. Now that the service has been up and running for a while, it is time to look back and learn some lessons from the main trends concerning regulatory publications. We conducted research over the last two years (2017 and 2016) to try to learn about the various regulatory trends, and, in this short document, we will try to outline some of the intriguing highlights.

There are four main takeaways: the first is the number of publications applicable to a typical financial institution (for example a commercial, investment or private bank). The RegWatch assesses regulations from a wide array of sources, and we usually identify on average between 300 and 400 applicable publications per month. Not all are necessarily game changers, implying major strategic shifts—some are just for information—but all are shaping the future of financial organizations. Secondly, there are, as we expected, identifiable regulatory cycles during a year, which

are usually repeated on an annual basis. Thirdly, and perhaps unsurprisingly, three areas that dominate publications are anti-money laundering/combating the financing of terrorism (AML/CFT), financial supervision, and capital requirements. The fourth takeaway is that with this flux of regulations, they became a core component in the strategy of any business organization or financial institution, and we can talk about the need of a regulatory strategy with its specific missions and contribution to the overall strategy of a firm. [➔](#)



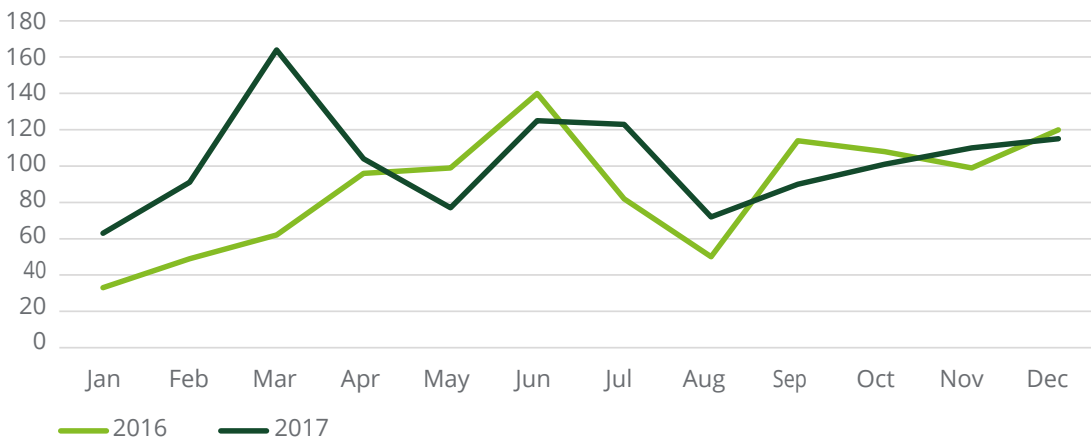


Regulations and trends

A. Regulatory overview

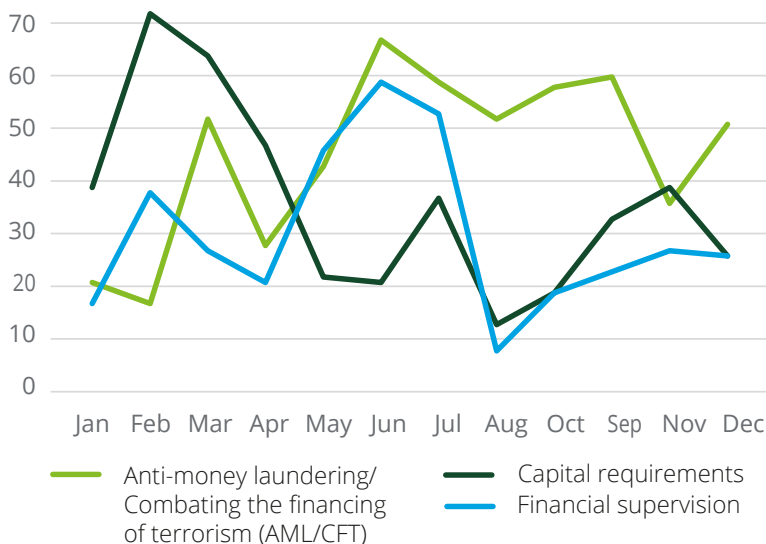
Table 1 displays the number of relevant publications in the years 2016 and 2017 at EU levels 1, 2 and 3. When looking at this chart, we can see a clear correlation between the specific months and the number of publications released during them in both years.

Table 1 - Number of publications at EU levels 1, 2 & 3 in 2016 and 2017.
EU Levels 1, 2 and 3



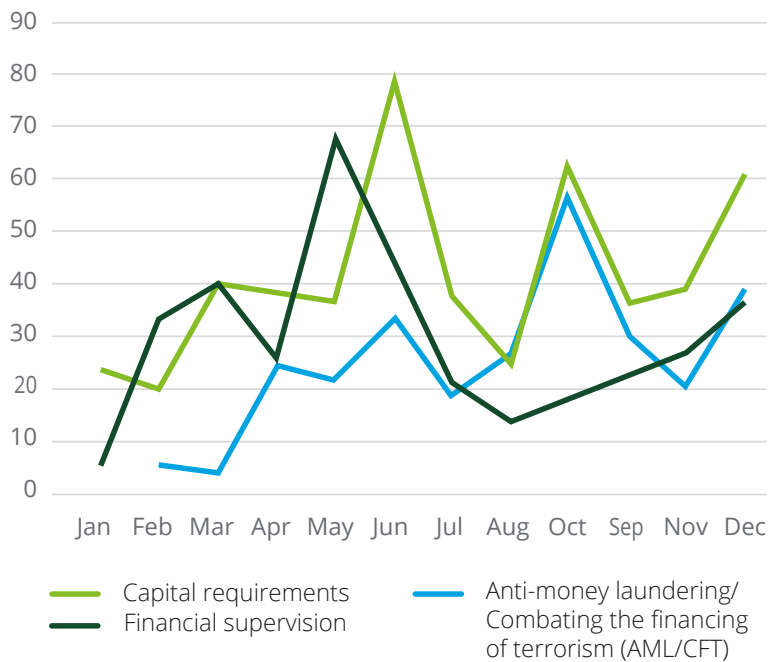
Similarly, when we look at tables 2 and 3, which display the number of publications at all levels (EU and national) for the top three topics in years 2017 and 2016 (respectively), we can see that there are repeated patterns during specific months each year.

Table 2 - Top 3 topics in 2017
Top 3 - 2017



There might be an additional potential cycle to test in April/May every five years with the recess of EU institutions and the need to publish before the election, but our analysis only covered the last two years.

Table 3 – Top 3 topics in 2016



In the financial sector, the UK being a key component in many markets, it is highly likely that some regulations will have to be reviewed, among them, MIFID II/ MIFIR with its market component.

For example, there are visible cycles of publications with peaks in December/ January and June/July. These can be explained by “human” factors. For example, the December/January cycle or the June/ July cycle might be linked to the summer and winter recesses, during which the number of publications drops significantly.

There might be an additional potential cycle to test in April/May every five years with the recess of EU institutions and the need to publish before the election, but our analysis only covered the last two years.

An interesting element about regulatory publication is that, beyond the generic cycle across the different levels, there is a cycle linked to the bodies who publish (from consultations, draft acts and finalized acts), from the level 1 measures from EU level to the level 2 or locally applicable laws.

It is noteworthy to see that this flux of regulations across all levels and within a given regulation translates into a constant flow of regulations to anticipate, comply with, and implement that last for periods of several years.

We even note that if there is a pause at level 1 (EU regulations or Directive), it is compensated by the technical layers or member state laws or circulars. Then another element is that even if there appears to be fewer publications at EU level, all regulations post-financial crisis include review clauses, leading to the current reviews of EMIR (II), UCITS and AIFMD cross-border, as well as a potential MIFID III.

To these review clauses, there is a likely major candidate that might trigger a host of regulatory initiatives over the medium

term, which is Brexit. In the financial sector, the UK being a key component in many markets, it is highly likely that some regulations will have to be reviewed, among them, MIFID II/MIFIR with its market component.

Thus, capturing regulations in their early stages allows companies to anticipate in what direction they are heading, which in turn leads to a smoother transition when applying them. Being able to leverage this by predicting what changes will have to be implemented or what new activities will have to be deployed in order to comply with the regulations gives companies a significant competitive advantage. In reverse, that also translates into the fact that “regulations never sleep”, hence the need to have a service that constantly analyses new regulations. ➔



B. Upcoming trends

Beyond the review of all regulations produced over the last 10 years, with a reduced likelihood of simplification, there are five new regulatory trends:

01. The fund industry has embarked on a new path with the publication in mid-March of a proposal to review the cross-border sale (or offer) of funds across the EU both for AIFs and UCITS. This should be accompanied by the often-announced, but until now postponed, AIFMD II and UCITS VI. These will obviously be critical for the fund industry, both in light of additional transparency as well as harmonization at EU level of management and distribution, at a moment when Brexit will affect delegation and outsourcing.
02. The second trend that has already started is the review of the EU supervisory bodies powers, or "ESAs review" (European Supervisory Authority: ESMA, EBA, EIOPA and ESRB). The objective of the review is to be more European, and thus giving

more power at EU Supervisory level to the potential detriment of national competent authorities. The transition has already been pursued for banks in the banking union project, handing most of the formal powers to the ECB. The review of the ESAs powers should mimic this approach for all financial firms, securities and markets. This project is under review, but could lead to even more rigor in the application of laws, as the soft touch that a local authority would have had might be lost in favor of a more streamlined approach. This translates as a need to be on top of regulations, even if only to avoid sanctions and their accompanying fines.

03. In spite of the attitudes of some countries towards the Climate Conference's famous COP (21, 22, 23...) the EU has decided to launch a host of regulations in the field of green and sustainable finance. They will move from a voluntary basis to a compulsory basis to touch all aspects of life in financial institutions, from the

services and products they provide to the management of offices, staff, etc. This new trend is here to stay, and started with the introduction of the sustainable component in the product and services proposal in MIFID II (green financial instruments, take into account investors' preference for ESG products or services) at the end of May. Changes are expected as well in the prudential regulation (CRD/CRR) to tilt loan offers in favor of green and sustainable projects.

04. Next, as it is now basically everywhere, is the digital world. Currently no regulation has been attributed in the right place of the digital world, be it in client contact, compliance or business process. This will change, probably through the review clauses mentioned above and digital solutions will become the primary solutions proposed to clients, with paper form becoming the alternative. This could give rise to some interesting debates about the recognition of client and AML/KYC distant assessment. Besides these, at every regulatory level from local to global and EU level, authorities cannot avoid to address cryptocurrencies regulations or ICOs (initial coin offerings at least), blockchain or other cyber risks management.
05. We should expect the launch of a 360 -degree initiative in the field of post-trade and securities markets. After the completion of EMIR (version I and soon II) might come the CSD-R review, the securities law and the custody regulation (excluded from MIFID II). This would finally present the opportunity to address segregation and bankruptcy remoteness. The approach might encompass some element of property rights and insolvency, but will be a systemic trend in the creation of a pan-EU securities market. ●

To the point

We can draw a number of conclusions from the analysis of the publication of regulations, but there are three main ones:

- Regulatory publications have never been so numerous; despite the migration from the defensive agenda following the financial crisis to a more pro-business orientation, the density of publications across all level remains stable overall.
- A consequence of this statement of fact is that the approach to regulation must change within financial institutions, from the old discrete approach taking projects one after the other to a more holistic deployment of regulations led by a core team who can anticipate regulatory trends.
- Next year will be a turning point in EU regulation, with the exit of the UK from the decision-making process (assuming Brexit proceeds as planned), the financial industry will see the first white papers and EU regulations produced without the input of the UK and fully led by the remaining larger EU member states.





European hedge fund managers' views on their prime brokerage relationships

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Executive Summary

We recently surveyed European hedge fund managers to better understand what they value about their prime brokerage (PB) relationships, strengths and weaknesses of their current providers, on what conditions they would consider changing PB's, and future challenges for their businesses. The PB market in Europe is highly competitive, with strong overall levels of service, quality people and efficient client technology interfaces. Top tier global primes still take on initially lower revenue generating managers with prospects for growth both within prime as well as the broader trading and investment banking franchise.

What hedge funds value:

- Counterparty strength is a fundamental prerequisite to compete in the prime brokerage market.
- Respondents highly value transparency and competitiveness of fees. They also indicated fees were competitive with minimal variations across the major players.
- Firms have high expectations for core PB services. Reporting, technology and operations are expected to be at a high standard. These are viewed as prerequisites in order for a PB to be considered and there is little perceived differentiation between the incumbent global PBs in these areas.
- Consulting and capital introduction are targeted resources that make a significant impact for certain clients on PB balances and revenues.
- Core services and strength of counterparty were most frequently ranked the most important headline factors for choosing a prime broker.
- Conversely, technology and fees were least frequently considered the most important factor by any respondent

Firms have high expectations for core PB services. Reporting, technology and operations are expected to be at a high standard. These are viewed as prerequisites in order for a PB to be considered...

largely because they perceived less room for differentiation in these areas. Expectations of technology platforms are high, with a focus on web portals for trade reconciliations and corporate actions management. Automated stock loan facilities are highly valued, with 94 percent of respondents currently using them.

Areas for improvement and why hedge funds change PB's:

- Overall, PB relationships are sticky, but hedge funds will change or add relationships if their firm grows to sufficient size therefore they can afford to add additional PB's without taking business away from current providers ("sufficient wallet size") or move to a perceived higher quality PB, if operational errors persist, and if they find more competitive fees.
- Conversely, the key barriers to adding or changing a PB are the associated operational difficulties and costs, insufficient "wallet", and investor communication and queries.

- The main points highlighted by respondents as areas for potential improvement within their PBs were fee transparency, reporting, core service offerings, and capital introduction.
- Cross margining could also improve. Hedge funds are increasingly trading a wide range of listed and OTC derivatives, equities, credit and fixed income and require PB systems to manage risk and margin across their entire book.

Challenges ahead:

- The most frequently cited challenges facing the hedge fund and PB market were MiFID II, capital raising and increasing transparency for hedge funds as the market becomes more investor oriented.



Survey approach

We held face-to-face interviews with a selection of European based hedge fund managers during the course of the survey and selected respondents to achieve broad market coverage across a variety of strategies and firm sizes. Coverage included ten distinct investment strategies.

The demographic of respondent investment strategies is represented in Figure 1.

The demographic of respondents by AuM is shown in Figure 2.

Our survey respondents manage funds whose number of portfolio positions vary widely, defined as the number of distinct commodities, securities or currency holdings that are either bought (long) or borrowed and sold (short). The managers surveyed also represented a wide variety of trading strategies ranging from very low turnover to one high-frequency trading firm, as measured by total market value of turnover.

The median gross exposure of our survey respondents was 200 percent of AuM, however there were a minority of managers who would hold a gross exposure of 500 percent or more of AuM. The majority of respondents tended to have a net exposure of ± 100 percent of AuM and less, with a median maximum net exposure of 40 percent. ➔

Figure 1. Respondent investment strategies

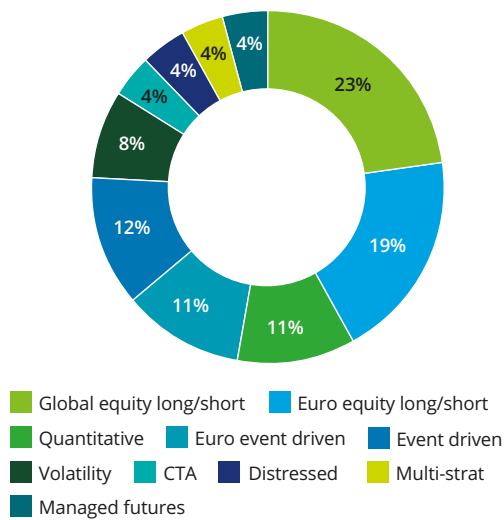
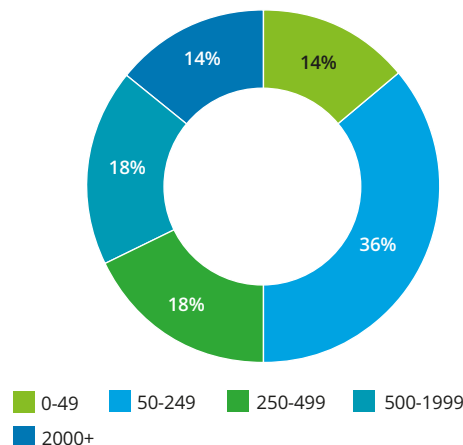


Figure 2. Respondents separated by AuM





Survey and results

Prime brokerage landscape in our sample

Our interviews corroborate the widely held industry view that a fund manager's pedigree and perceived ability to raise capital is highly correlated with the type of PB relationships they maintain. The European PB market may be split into the following segments:

- **Incumbent global PBs** may either be investment banks or universal global banks defined by longevity, market share dominance, and brand. Typical clients are start-ups with pedigree and asset raising potential, and established managers
- **Enhanced custody PBs** are typically prime brokerage businesses that grew out of custody services and businesses. Typical clients are established managers with large AuM and a focus on strength of counterparty who are looking for additional PBs, and solutions for cash and custody
- **Specialist PBs** where typical clients are established firms looking for bespoke stock loan, market access or margining solutions, and capital introduction in certain markets. These PBs also position themselves to take on new start-up managers with aligned trading strategies who are not big enough for the Global PBs and enhanced custody PBs
- **Introducing broker mini-primes** Where typical clients are managers with less asset raising potential who cannot access the Global PBs, and established managers who are forced off larger PB platforms, or are unwilling to pay larger PB minimum fees
- **Trading arcades, incubator, enhanced brokerage accounts**, When typical clients are smaller managers managing their own capital, and family offices. These are not typically on the radar of hedge fund investors therefore asset raising potential is limited beyond friends and family

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Number of players and new entrants in our survey

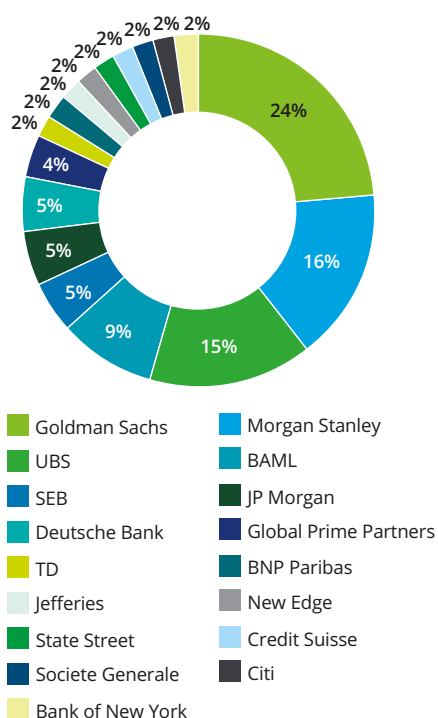
Our survey respondents used seventeen separate PBs. These PBs may be stratified as per the groupings shown in Figure 3.

Figure 3

Prime brokerage category	%
Global PB	35%
Enhanced custody PB	29%
Specialist Mini-prime	29%
Introducing broker Mini-prime	6%
Trading arcade	0

Accounting for respondents who hold multiple hedge fund relationships, the incumbent Global PBs represent 71 percent of PB relationships we encountered, which demonstrates their ability to provide services for hedge funds of all sizes. Figure 4 sets out the observed frequency of relationships held with PBs.

Figure 4. Frequency of relationships with prime brokers



Hedge fund managers in the European market have a large number of PBs from which to choose, leaving minimal residual demand for generalist PB services.

Highly competitive market

Data obtained from this survey, and opinions expressed by survey respondents, suggest that hedge fund managers in the European market have a large number of PBs from which to choose, leaving minimal residual demand for generalist PB services. Hedge funds have historically provided banks with an important source of trading revenues; hence many players have invested in prime brokerage and other alternatives servicing businesses to provide a constant flow of new clients to their firms. This is reflected in our survey, where respondents observed the following:

- Many global PBs are still supporting lower AuM managers
- PB is a highly sales driven industry where new 'wins' are highly sought after
- PBs viewing their relationships with fund managers holistically, within the context of the broader franchise sales and trading revenues
- Front office sales and trading teams at the tier one banks know the portfolio managers and traders with good track records at each firm. At these firms often

the "number two or three" portfolio managers leave to create new firms and the sales coverage at the tier one banks, either securities sales and trading or PB, are often the first to know and help. Therefore the top-tier PBs often have the first pick of the managers most likely to succeed in raising capital

- Willingness by some global PBs to 'take a bet' on less established managers
- Fewer hedge fund launches
- Compressed margins on existing clients, which have resulted in the need to push greater volumes through PBs' platforms
- Survey respondents perceived the fee landscape in the European PB market to be highly competitive. Although respondents did not perceive fierce pricing competition between PBs, pricing is highly consistent between providers [➤](#)

What hedge funds value about prime brokers

We developed a list of six 'headline' factors that could influence a hedge fund manager's choice of PB providers; these were core services, strength of counterparty, fees, franchise, relationship and technology. Within these factors we compiled a list of more detailed 'sub-factors' that hedge funds would consider. These were:

We developed a list of six 'headline' factors that could influence a hedge fund manager's choice of PB providers



Core services

- Financing and leveraging
- Margin cross margining across asset classes
- Accurate and transparent margin calculations and valuations
- Securities borrowing and lending (including stability of stock borrow and minimum recalls)
- Client services (asset servicing, corporate actions, clearing and settlement)
- Client on-boarding and transition (ease and speed of on-boarding new clients across asset classes)
- Legal documentation and process
- Capital introduction; Consulting



Counterparty strength

- Credit rating
- CDS spread
- Bankruptcy vehicles



Fees

- Competitiveness of fee structures;
- Transparency of fee structures



Franchise

- Research, sales and trading ideas/coverage
- Brand
- Range of products/services offered
- Global coverage
- Trade execution
- Investment banking (equity capital markets and debt capital market franchise)



Relationship

- Good relationship with PB
- Access to front and back office personnel (e.g. senior management)
- Individual PB contacts



Technology

- Easy to use systems
- Flexible and bespoke reporting

Headline factors

We asked respondents to rank, on an exclusive basis, the six headline factors from 1 (most important) to 6 (least important). Core services and strength of counterparty were most frequently ranked the most important; conversely, technology was only considered the most important factor by one respondent, and fees were not considered the most important factor by any respondent.

We also reviewed the factors consistently ranked in the top three. Further to this, counterparty risk was the factor most frequently ranked within the three most important factors with core services second most frequently. This demonstrates the criticality of these factors to hedge fund managers in their PB choice. Despite no respondents ranking fees as the most important factor in PB choice, 20 percent

of respondents ranked fees within the top three most important factors. In discussions, managers indicated fees needed to be within a competitive range rather than negotiating to the absolute lowest level. Manager's recognized pressure on PB balance sheets (and hence fees) because of capital requirements and regulation. In addition many respondents acknowledged that there is an important balance between service and fees.

A consistent comment among respondents for the top three factors was that these three were pre-requisites and expected to be of high quality and competitive just to compete in the PB market. Results are shown in Figure 5.

A PB's counterparty strength is a prerequisite for managers and their investors. Many respondents stated that,

although possibly not rated the most important in their own responses, if a manager has any concerns around the counterparty strength of a PB they would not consider entering a relationship.

Two mandatory PB prerequisites referenced by almost all respondents that indicate strength of a counterparty are:


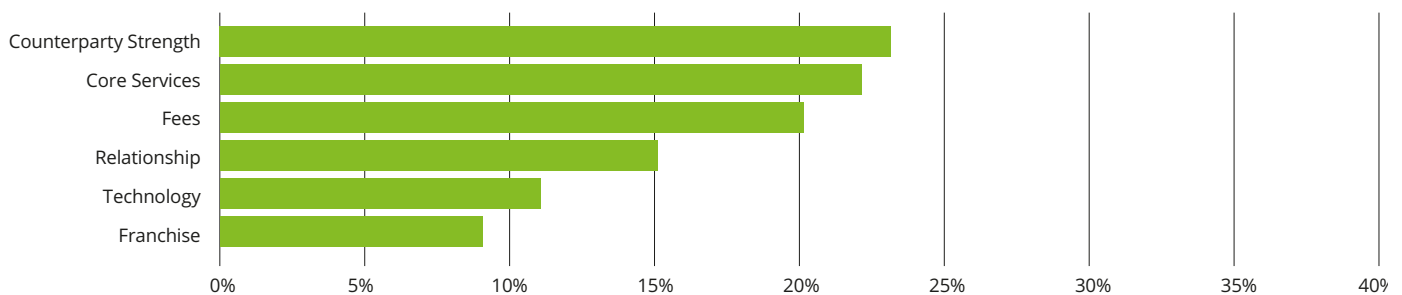
- **Solid credit rating:** All respondents monitor their PBs' credit ratings, balance sheets and CDS spreads. Some also monitor their PBs' peers' credit ratings to assess the systemic risk in the market; others also use industry forums and peer groups to assess market intelligence.
- **FCA regulated** 

Figure 5. PB relationship decisions

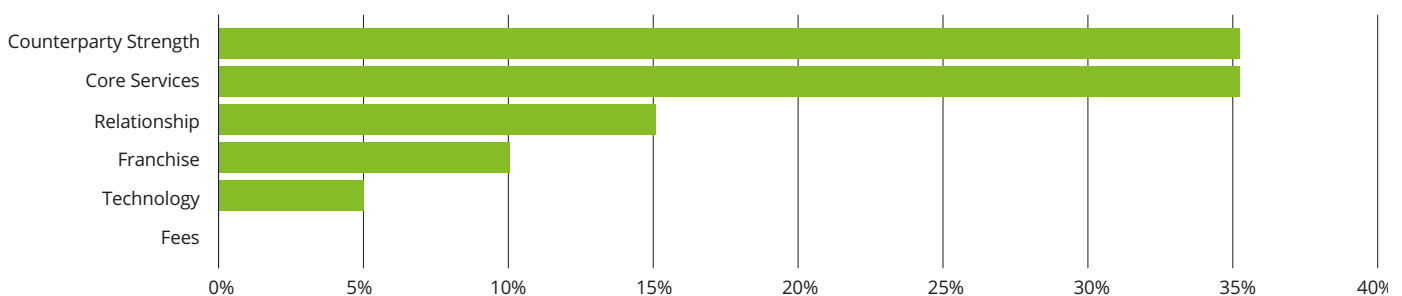
Importance of factors in PB relationship decision

Frequency ranked top 3 most important



Ranking of headline factors in PB relationship decision

Frequency ranked most important



Sub-factors

We asked respondents to rate each of the sub-factors that could influence a hedge fund manager's PB choice, from 1 (very important) to 6 (unimportant) on a non-exclusive basis. Based on these scores we calculated arithmetic means to determine which sub-factors scored the lowest (i.e. were considered most important).

Good relationship with PB; access to front and back office; and individual PB contacts were the three sub-factors that, on average, were considered most important. Brand; capital introduction and consulting; and investment banking were considered the least important sub-factors.

The findings on value added services (capital introduction and consulting) are interesting and displayed the widest

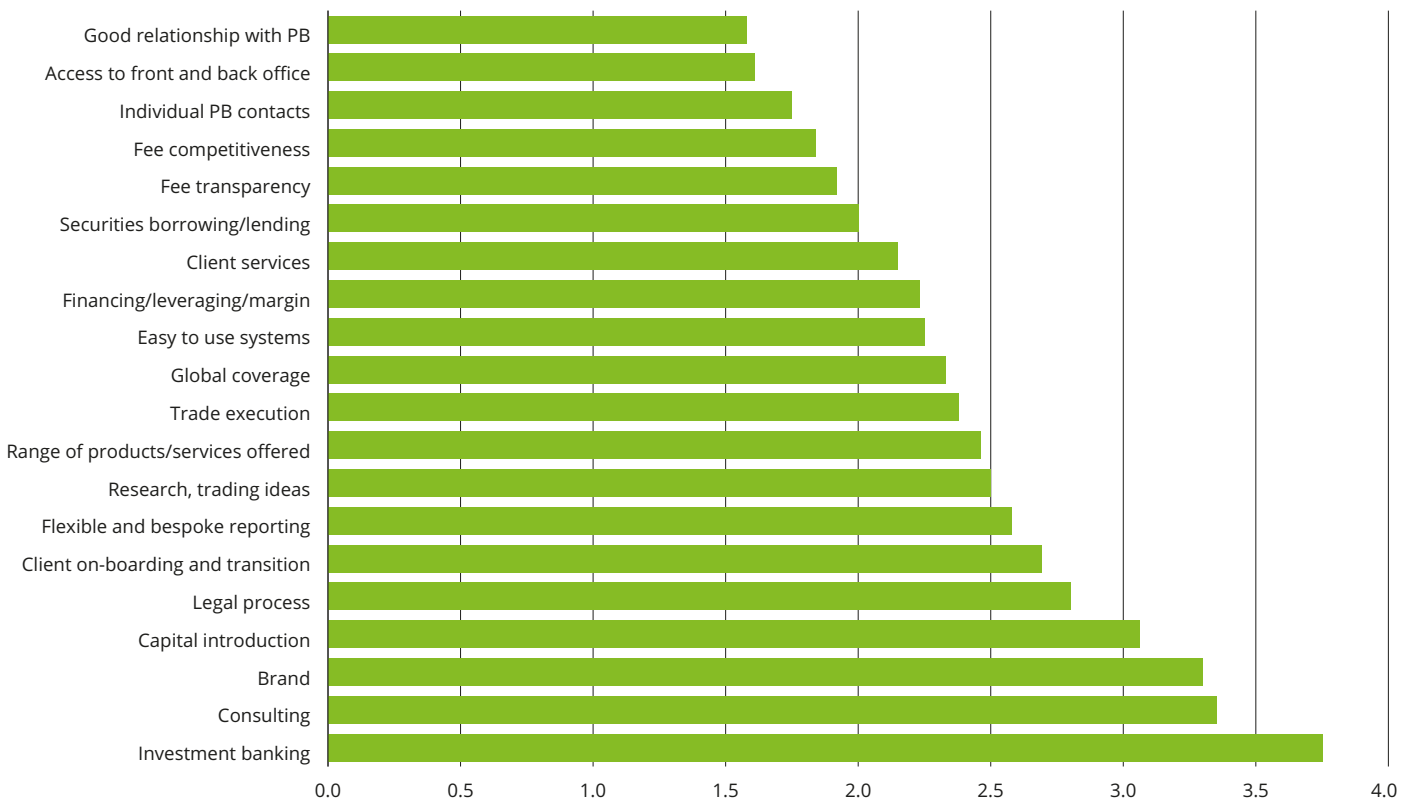
variation in ranking. However, these results may be better explained in the context of manager responses in the subsequent sections on prime brokerage strengths and weakness as well as changing and adding PBs.

Based on an equity-focused set of hedge fund manager respondents, securities borrowing and lending was considered the most important core service, followed by financing, leverage and margining; and trade execution. Figure 6 sets out the average score of each sub-factor across the respondents.

Value added services

Value added services such as Capital introduction and Consulting are typically high impact, time consuming and targeted at specific clients to demonstrate commitment. These services are often associated with a deeper partnership to grow a hedge fund manager's business and AuM, resulting in an increase in PB balances and revenues. The results of this survey demonstrate a wide variation in the perceived value of these service as they were ranked very highly by those who receive them, and those who do not receive them offered comments on how they could be improved.

Figure 6. Average score of sub-headings





Prime broker relationships

We asked respondents about the number of PB relationships they had and their reasons for holding as many as they do. We then explored how managers distribute balances between their PBs, and their PBs' strengths and weaknesses. Finally, we explored what would cause managers to change or add a new PB and the barriers that they perceived to doing this.

Prime brokers as a portal to the rest of the franchise

For many hedge funds, the PB relationship is the first contact they have with a bank and expect their PB contacts to act as a portal to the rest of the firm. They expect banks to recognize in their client service tier structure the fees they pay across the bank. Hedge fund managers understand

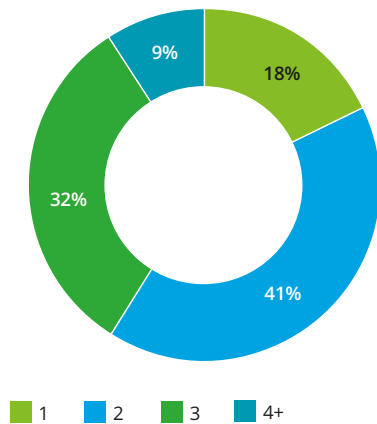
service tiers, and prefer to engage in an active and healthy dialogue regarding what level of PB service they can expect for the fees they pay.

What hedge fund managers expect out of the relationship differs according to the strategy and personal preferences at each firm. Outside of core PB services, hedge funds will use their PBs' 'wallet' to access:

- Sales coverage
- Trading (block deals, execution, DMA)
- Research, analyst and company meetings
- IPO access
- Balance sheet trades (Banks shedding non-core assets)
- Issue resolution ➔

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Figure 7. Number of prime broker relationships by manager



Existing prime broker relationships

82 percent of survey respondents held more than one PB relationship, ranging from the use of two to seven counterparties (graphically represented in Figure 7). Some respondents stated that they use multiple PBs because of the niche specialisms or unique market access granted by PBs; others stated that they use multiple counterparties as a precaution to manage credit, and counterparty, risk, and to satisfy investor requirements. Many of these respondents highlighted that the increased focus on strength of counterparty management amongst fund managers following the collapse of Lehman Brothers had meant that the use of multiple PBs was now common practice amongst fund managers and a prerequisite to raising capital.

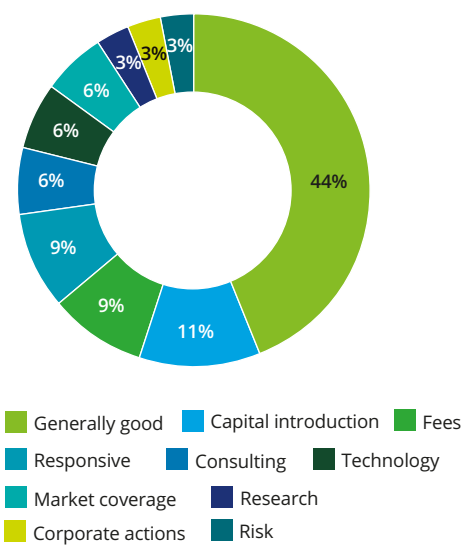
Strengths

When respondents were asked about their satisfaction with their current PBs, 44 percent of respondents expressed that they were “generally happy” with the level of service and 11 percent responded that capital introduction and consulting was a key strength. They also highlighted strengths in competitiveness of fees, responsiveness, technology and market coverage. Figure 8 presents results in full.

Areas for improvement

When respondents were asked about the areas that their PBs could improve many did not have any material problems with their PBs. The main areas of potential improvements for respondents’ current PB suppliers were Fee transparency, Reporting, Core service offerings and Capital introduction services. Figure 9 presents results in full.

Figure 8. PB strengths



The key drivers behind the allocation of balances between PBs were the commercial ‘wallet’ they could spend in relation to service they receive (as described above); their PBs’ relative operational and cost efficiencies; and the relationship and service levels between PB and hedge fund manager, taking into account value added services such as capital introduction and consulting. In addition to their own preferences, respondents would take into account their PBs’ preference for balances they would prefer to hold, and would aim to satisfy PBs in order to maintain the relationship, if this meant slightly higher costs or reduced overall efficiency.

Value added services such as Capital introduction and Consulting are typically high impact, time consuming and targeted at specific clients to demonstrate commitment. These services are often associated with a deeper partnership to grow a hedge fund manager’s business and AuM, resulting in an increase in PB balances and revenues. The results of this survey demonstrate a wide variation in the perceived value of these services as they were ranked very highly by those who receive them, and those who do not receive them offered comments on how they could be improved.

Prime broker strengths and weaknesses

The overall high level of satisfaction amongst managers suggests that the general standards of service are high.

Changing and adding service providers

When asked about adding and changing PBs survey respondents almost universally saw this to be a difficult process with potentially limited upside, however most respondents displayed some willingness to add or change service provider under the appropriate conditions.

Survey respondents provided reasons that they might choose to add another PB or change their current service provider. Key reasons given to change or add a PB were:

- Growth of AuM
- Persistent operational errors or financial losses
- Lower fees offered by competitors

Figure 10 presents results in full.

When asked about the barriers that they perceived to adding or changing PBs, the key barriers perceived were:

- Associated operational difficulties
- Insufficient 'wallet'
- Associated cost
- Investor pressures

Figure 11 presents results in full.

The concentration of responses suggests that the "operational headache", legal burden and large financial cost of on-boarding a new PB or changing current PBs are perceived to be strong barriers to change for fund managers. ➔

Survey respondents provided reasons that they might choose to add another PB or change their current service provider.

Figure 9. PB areas for improvement

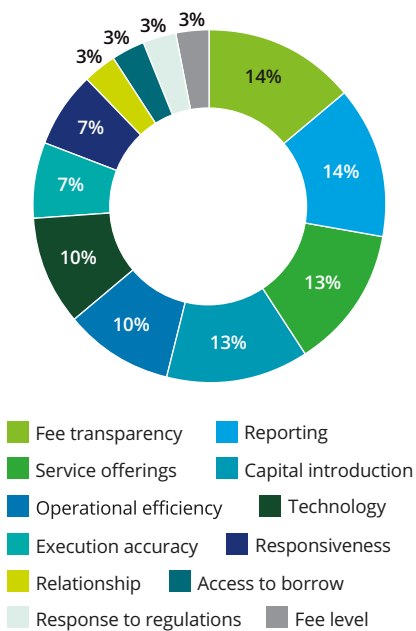


Figure 10. Reasons to change PB or add a new PB

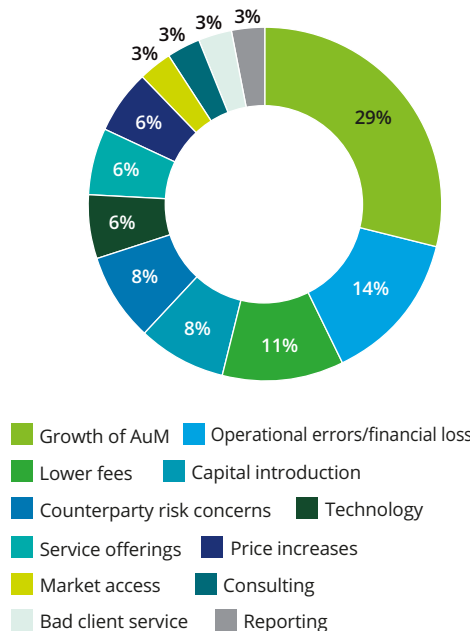
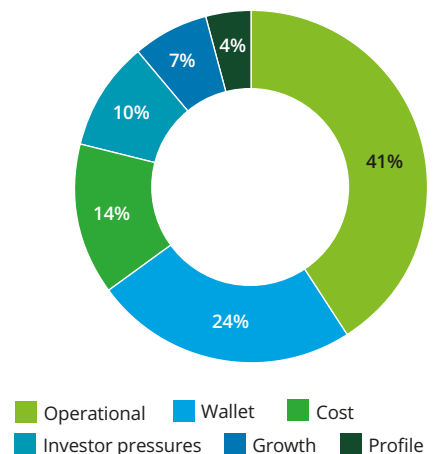


Figure 11. Perceived barriers to adding or changing PBs





Respondents tend also to download reports from the PB platform to perform their own separate reconciliations.

Technology

We asked survey respondents about their technology platforms and technology requirements.

Many respondents expect PB relationships to be a seamless experience, both operationally when requests are made and via the PB's platform. 89 percent of respondents currently make use of their PBs' automatic web payments (see Figure 12), whilst all respondents require automated feeds to their own reconciliations.

Some respondents indicated they would like to see systems that offer consolidated margining functionalities (e.g. OTC positions with equity book) across the bank. Given it is normal for banks to carry out these activities across different desks, it is difficult to get the systems and risks teams to effectively offset risks across desks and report on them in a consolidated fashion. This capability is important to firms trading OTC derivatives that offset or hedge the risk in other parts of the portfolio, bonds or equities for example and would like the

Figure 12. Proportion of respondents that currently use automated web payments

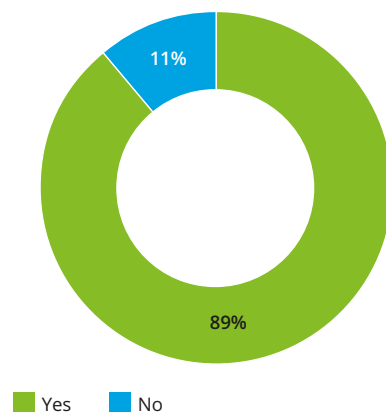
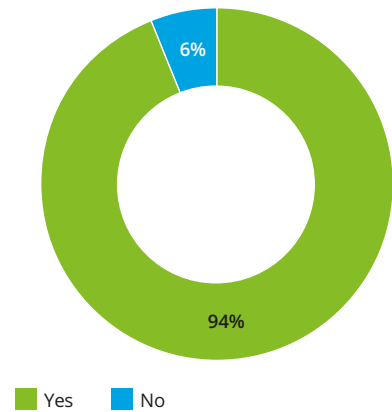


Figure 13. Proportion of respondents that use automated stock borrow locate files



This represents strong demand for the service and respondents indicated that, dependent on a manager’s strategy, this could be pivotal to their decision about PB provider.

bank to recognize these offsetting positions in their margin calculations.

Respondents tend to use the PB platform to investigate PB’s reconciliations in the event of suspected errors. Respondents tend also to download reports from the PB platform to perform their own separate reconciliations.

94 percent of respondents currently use automated stock loan locate files offered by their current PB service providers

(see Figure 13). This represents strong demand for the service and respondents indicated that, dependent on a manager’s strategy, this could be pivotal to their decision about PB provider.

80 percent of respondents use automated corporate action services as part of their PB package (see Figure 14), and 50 percent currently have direct contact with service representatives who can advise on corporate actions (Figure 15). ➔

Figure 14. Proportion of respondents using an automated solution for corporate actions

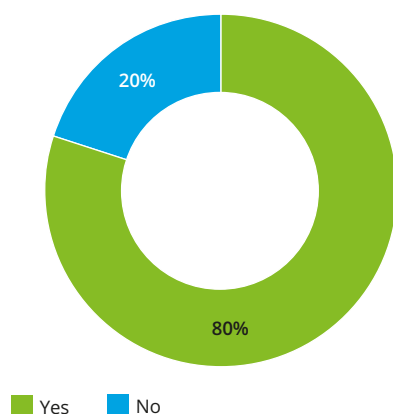
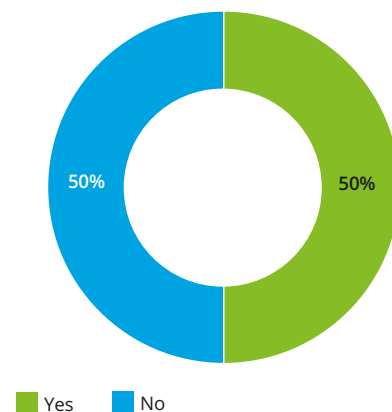


Figure 15. Proportion of respondents using service representatives for corporate actions





Technology build and investment

A majority of respondents automate operational aspects of their business as much as possible using their own systems. Survey respondents often rely on PB portals for web payments, trade break and corporate action services, and in some cases borrow and locate services. Respondents often stated that a PB platform that is sufficiently flexible to work in synchronization with their own technology is crucially important in deciding on a counterparty in order to minimize operational difficulties.

Direct Market Access (DMA)

The array of third party trading technologies currently available for execution and trade order management mean hedge funds rely less on their prime brokers' own DMA offerings. Several respondents expressly commented that they would not rely on a broker's own DMA offering. Given MiFID has significantly changed the market infrastructure we expect manager demand and vendor offerings in this area to develop further in the coming months and years.

Given MiFID has significantly changed the market infrastructure we expect manager demand and vendor offerings in this area to develop further in the coming months and years.

Web portal requirements

Web portals were often cited as an important tool prime brokers use to present a consolidated view across often disparate systems within the prime broker. For example, web portals give a hedge fund manager a consolidated view of their:

- Portfolio positions
- Currency exposures
- Margin by position
- Re-hypothecation
- Corporate action calendars
- Stock borrow locates
- Reporting

These portals were also seen as a minimum requirement but also assist a PB's client services staff to provide an efficient service to hedge fund managers – giving them necessary information but also deflecting time consuming client queries that can be easily answered through transparent reporting, therefore enhancing profitability of the service.

Value added services such as Capital introduction and Consulting are typically high impact, time consuming and targeted at specific clients to demonstrate commitment.

Hedge fund market trends, opportunities and challenges

Many respondents stated that the increased competition within the PB market is symptomatic of a market that has matured and increased in transparency in recent years.

Going forward, respondents saw a challenging environment for hedge funds:

Performance

- Many respondents have predicted that hedge fund managers will continue to encounter difficulties in raising funds as they are pushed by investors on performance. One respondent went further to suggest that this may lead to a consolidation of the industry and a reduction in the number of start-ups that can successfully establish themselves in the industry.

Regulation

- MiFID II was an issue highlighted by most respondents as a challenge.

Fees and fee transparency

- Respondents are observing continued movements towards an investor oriented industry with compressed fees as transparency continues to increase and investors become price makers; one respondent commented that hedge funds need to become more “investor-minded” in order to ensure that the hedge fund market remains sustainable. Respondents suggest that this is likely to continue to apply pressure on funds to perform and to reduce management fees.

Figure 16 provides a visualization of the frequency with which key words arose during interviews. From this it is evident that MiFID II and regulation are the biggest concerns, followed closely by hedge fund performance. ●

Figure 16. Visualisation of frequency



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06 December



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- RPA (Robotics) in IM Industry
08 November

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