

Performance

A triannual topical digest for investment management professionals, issue 9, September 2012



Market buzz

Social media – A splendid opportunity for fund promoters and asset managers

Art-secured lending – Unlocking the liquidity of your clients' art collections

Passing the baton – Hedge fund succession planning

Internal audit – The need for a risk guardian in asset management companies

Performance monitoring in asset management – The importance of a customised monitoring system

External perspective

OTC derivatives – Meeting the new regulatory challenges

Senior secured credit – When two become one

EMIR—Dodd-Frank – A challenge for European assets management firms and their custodian banks within a non-stabilised regulatory framework

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Foreword



Dear investment management practitioners, loyal readers and newcomers to our magazine,

First of all, we hope you all had an enjoyable summer break with your families and friends and would like to wish you a great start to the new investment management season ahead of us. The *Performance* team has been following the latest industry trends and this ninth edition focuses on current and emerging challenges, issues and, most importantly, opportunities.

It goes without saying that we are living through very challenging times for our industry. Key front of mind issues that we will have to resolve include regulatory compliance (e.g. AIFMD, FATCA, IFRS, MiFID II, PSD, Solvency II, UCITS V), acquisitions strategy, governance and oversight responsibilities, risk management, technology and data quality, international market evolution, sustainable growth or retaining and training our human resources, to name but a few. As for the international markets, the uncertainty surrounding the EU sovereign-debt crisis underlies most of the topics listed above. We can be sure that, as a result, we will see regulatory change, asset disposals, acquisitions and re-capitalisations in the coming months.

As an industry, we believe that it is vital that we develop one voice and a common language so that we can play our part in shaping the future of the industry and influence the development of market initiatives and regulatory reforms. Given the current market dynamics, our involvement in and contribution to different industry initiatives is more important today than ever before.

As usual, we hope you enjoy reading this edition of *Performance* which would not have been possible without your interest and support.

A handwritten signature in black ink, appearing to read 'Vincent Gouverneur', with a stylized flourish at the end.

Vincent Gouverneur
EMEA Investment Management Leader

A handwritten signature in black ink, appearing to read 'Chris Harvey', with a long, sweeping flourish extending to the right.

Chris Harvey
Global Financial Services Industry Leader

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

Editorial

Welcome to the ninth edition of Deloitte's global investment management magazine.

As the post-holiday season begins, we believe the new issue will be full of useful market insights. This time, we are delighted to see our external contributors again increasing in number. It is a major objective of *Performance* to open our forum to key industry actors and stakeholders outside the Deloitte network. We are particularly grateful to all the external contributors from CACEIS, ECM and Société Générale for making this magazine so special and a real discussion platform for the industry.

For the September edition, we present to you articles on social media, securities lending on art, succession planning for hedge funds, internal audit in asset management, performance monitoring in asset management, new regulatory changes for OTC

derivatives, senior secured credit asset classes, EMIR, Aberdeen and Santander tax reclaims, FATCA and results of our AIFMD survey.

Please get in contact with us and share your thoughts on the different articles published in this edition or on any investment management related topic. We hope you enjoy this new edition of *Performance*.

Sincerely,



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Editorialist



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Social media

A splendid opportunity for fund promoters and asset managers

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“We have technology, finally, that for the first time in human history allows people to really maintain rich connections with much larger numbers of people”, Pierre Omidyar, Founder of eBay

Social media platforms are starting to bear a significant resemblance to Rome’s ancient gladiator arenas. It’s the place to be to share the latest news, meet friends, be entertained and do business. Luckily, in the digital arena it’s no longer a question of life or death; the fight is about reputation and positioning.

The major difference is that everybody in this arena can be a gladiator, spectator and salesman at the same time. Everybody can talk with and about everybody—and everybody is talked about.

Our modern gladiators are people like you and me, but also more and more institutions, brands and public events are entering the arena. Everybody can join in.

If you’re in the arena, others can ‘fight’ you, and you can react, show your skills and ally with others.

If you don’t enter the arena or decide to leave, you won’t hear the fights, the screaming and the applause anymore. You might feel safe, but the others won’t stop talking about you; it only means you can no longer defend yourself, share your thoughts and distribute your goods.

Today’s biggest arena was built by Mark Zuckerberg. Eight years ago it was unthinkable that his little playground Facebook would grow into a 900-million-user arena accessible from anywhere in the world. Facebook’s story represents the success of a whole media revolution induced by web 2.0 technologies—the emergence of social media. The triumph of social media today is undisputable. What started out as a simple idea of giving a voice to every digital surfer turned into an arena of incredible size, and we’re all in there, either actively or passively.

If you don't enter the arena or decide to leave, you won't hear the fights, the screaming and the applause anymore



The fund industry and social media

Deloitte conducted a study about the use of social media in the fund industry in the USA, Europe and Asia. We analysed different players in different jurisdictions, their positioning, goals and major challenges.

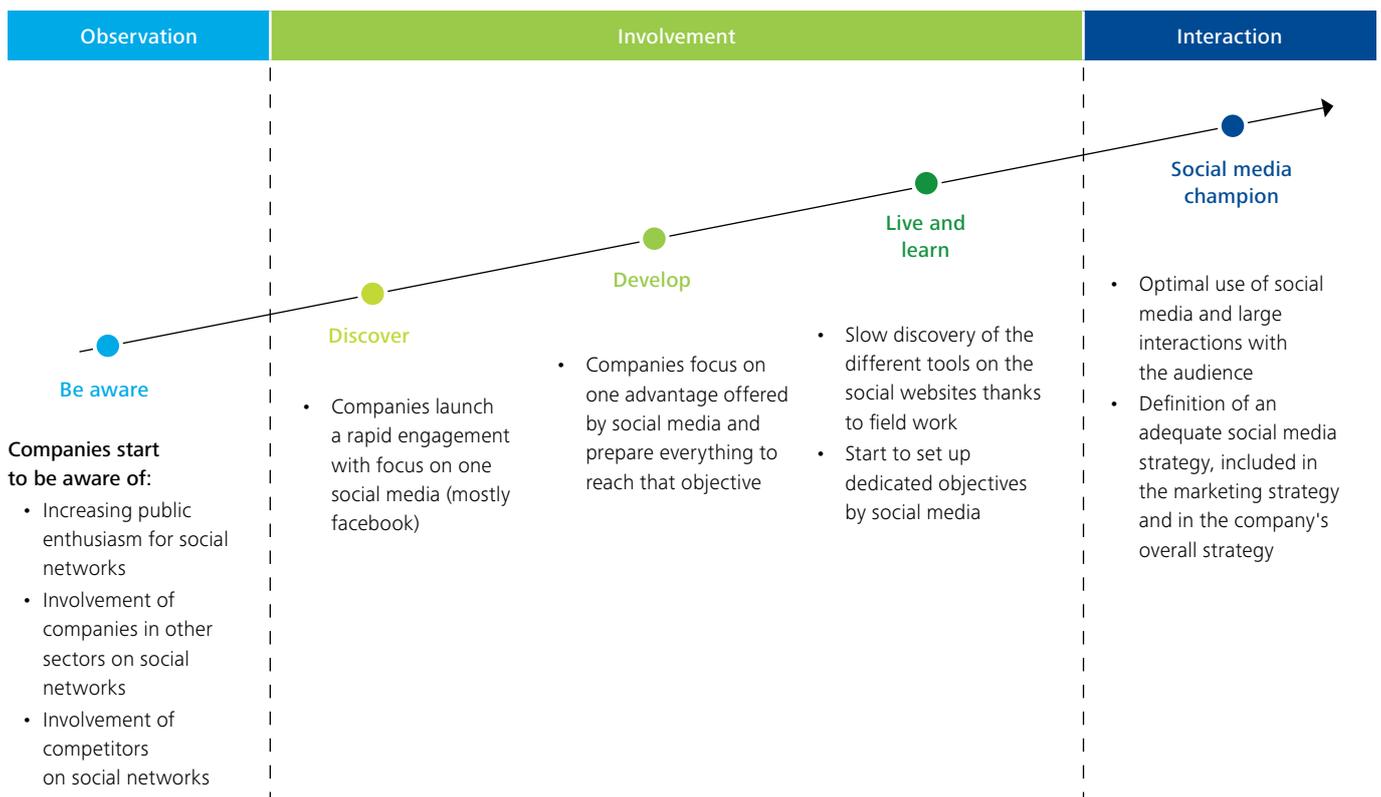
In all analysed markets, the target group of social media activities are retail investors, who can be divided into two groups, the 'young' and the 'old', referring both to investors' age and investment experience. Social media primarily target the younger generation, the so-called 'digital natives' who feel most comfortable in social networks. When using social media for communication and reputation reasons, all potential investors can be addressed—even institutional investors are reached indirectly through improved public recognition. What follows is a presentation of some of the study's most relevant findings for the use of social media in the fund industry.

In a retail investment fund's typical distribution process, the fund promoters and/or asset managers are cut off

from the final customer. It is not the fund promoters themselves that have final contact with the client at the time of sale, but rather intermediaries such as fund distributors, transfer agents and custodians. As client information is a crucial part of market/customer analysis, brand management and product development, it is essential that you know your customers and understand their needs. In the traditional fund distribution process, this valuable information is frequently lost along the way.

Social media can enable fund promoters to reconnect with the end investor by creating a two-way dialogue between the two parties.

A firm's participation in social media can generally be described as having three phases. After an initial, relatively passive exploration phase, the social media presence grows in terms of interaction and content richness until the firm ultimately becomes a social media champion that proactively shapes and manages its social media activity.





Our analysis of the social media activity of major asset managers from the USA, Europe and Asia reveals that U.S. and UK asset managers have taken the lead in developing a social media presence while European and Asian players still have very little social media activity. U.S. and UK market players are continuously extending their social media presence by successfully enriching their activity content and applications. For instance, they offer financial literacy services by providing 'followers', 'friends' and 'subscribers' with fresh market insight or explaining essential investment fund-related notions. Some players even use games to wrap and deliver this type of content and make it more accessible to the general public.

Instead of using social media to directly sell investment funds, asset managers can use it to increase their visibility or to be recognised as trusted experts. Moreover, interacting with potential customers on social media gives asset managers the chance to position themselves closer to their investors and build a better relationship with existing and future clients. Regularly commenting on and discussing market events, posting expert analyses, providing financial literacy services or organising polls on various subjects strengthen this positioning. The ultimate goal is to increase brand recognition and value and to generate indirect sales for the company. One must bear in mind that interaction is key. Social media should not be seen as an additional distribution channel for existing information (i.e. many asset managers already publish market analyses on a regular basis) but as a way to substantially enrich communication by making it interactive.

“By not tweeting you’re tweeting – you’re sending a message”,
anonymous Twitter user



Asset managers and fund promoters can therefore benefit from a social media presence. European players especially can differentiate themselves in this crowded market by becoming a 'social media champion' and therefore getting closer to the end investor than their competitors.

Three major challenges in using social media for business purposes

Fund promoters and asset managers, like anyone else willing to enter the sphere of social media, face three major challenges:

- Continuous management of the social media activity
- The social media dashboard—measuring the return of a social media strategy
- Legal aspects when using social media to communicate with the customer

Continuous management of the social media activity

As mentioned before, interaction is key because it enriches the existing (mostly one-way) communication with the client and shows that firms care about their customers.

Not communicating sends a message that is at least as powerful as the message you send by communicating. It is a common misconception among firms that not being present on social websites prevents others from talking about you—discussion about you happens whether you participate in it or not.

“What is the ROI of your mom?”, Gary Vaynerchuck, Founder of Wine Library TV

Being active on social websites not only gives a firm the opportunity to listen to what is said about them but also to react to it (e.g. criticism). Therefore, we strongly believe that there is more to gain than to lose for firms on social websites, especially if one considers the relatively low cost of reaching this massive audience.

A social media presence should be managed differently from other websites. Unlike most websites, social media sites create a mix between static and dynamic information. Whether it be status updates and comments, chats with followers or polls, all these make social media sites more dynamic than traditional websites.

When planning the traditional web-presence of a company (i.e. website), the focus is on what to display and how to display it to the visitor. With social media, however, the additional question of how to interact with the visitor must be answered. The interactivity of a social media presence can be defined flexibly by the firm. It can allow followers to comment on all posts or only some—or even reserve the right to comment for a specific group of people. In the same way, the firm can decide on whether it wants to react to posts and comments or not. However, a rule of thumb is that the more open and interactive a social media site is kept, the more interest it will create and the more success it will have.

Firms should therefore allocate sufficient resources to the continuous management of the social media activity. Responding in the right way to posts, for instance, creates the sentiment of proximity and reachability. This in turn fosters a feeling of trust and confidence in the firm, which creates a fertile ground for the sale of financial products especially.

“One part of my job that I really enjoy is talking directly with investors. Social media, with its ever-expanding reach, offers a great way to do that.”,
Bill McNabb, CEO at Vanguard

The social media dashboard—measuring the return of a social media strategy

Measuring the exact (financial) return of a social media campaign is almost impossible. At the moment, there is no clear consensus among experts on how best to measure the impact or return of a social media strategy. However, we think it is all about measuring the right KPIs to get as close as possible to the exact measurement of your business goals.

The KPIs of a social media strategy should ideally be the direct interpretation of company strategy goals in social media terms. One common mistake at this stage is selecting KPIs which are traffic-related instead of business-related. For instance, many companies use the number of 'likes' or 'followers' on Facebook or Twitter as a primary KPI. These may be the right KPIs for a professional blogger who is blogging for the sake of blogging, but a company using social media activities as a tool to increase sales should pick more business-related KPIs, e.g. the number of sales resulting from an advertisement on Facebook. This can easily be measured using modern sales tracking methods.

The return of a social media strategy like posting a comment on the company is diffuse and hence difficult to measure with one KPI. Sure, traffic indicators such as the number of 'likes', 'friends' and 'followers' are tempting and interesting metrics, but must always be complemented by a series of business-related metrics, ideally both qualitative and quantitative in nature.

We therefore recommend creating social media dashboards including a comprehensive set of indicators which mix:

- Qualitative and quantitative indicators
- Company strategy and traffic-related indicators
- Long- and short-term impact measures

Legal aspects when using social media to communicate with the customer

Whenever there is a new, rapidly growing and evolving field like social media today, plenty of new legal issues will arise. The law cannot foresee future developments and therefore does not cover all eventualities. The best advice is to proceed carefully and consult with an expert for information specific to your individual case before really getting started.

U.S. players did not only take the forefront in using social media, but they also have the most advanced legal situations, including specific regulations on social media for the financial industry. To provide guidance on this topic, FINRA issued Regulatory Notice 10-06 and 11-39. Essentially, it updates the existing regulation regarding social media and reminds firms of the record keeping, suitability, supervision and content requirements for (public) company communications.

For instance; if a firm or its personnel recommends a financial instrument (i.e. a recommendation as defined by the NASD) through a social media site, it must determine whether it is suitable for every investor to whom the recommendation is made. This requires the publishing firm to carefully control access to the communication.

In Europe, there is no such specific regulation addressing the social media activity of financial institutions. European regulations originate from multiple law texts such as the data confidentiality law, telecommunication and media law or the law on fair competition, to name a few. Therefore, it is more difficult to get a clear overview of the relevant social media regulations than it is for U.S. players. Nevertheless, our study revealed that some European and especially German asset managers and fund promoters have successfully implemented social media strategies over the last few years, proving that legal aspects are an important point on the fund promoters' social media check list but not an obstacle preventing them from engaging in social media.

To avoid any uncertainties, it is essential to look beyond national law because social networks are a borderless space with parties from different jurisdictions involved. We believe that if anticipated and managed appropriately, these legal risks will not harm the effectiveness of the firm's social media activity.

“When you give everyone a voice and give people power, the system usually ends up in a really good place”, Mark Zuckerberg, CEO & Founder of Facebook

A comprehensive approach towards implementing and managing social media strategies

Social media strategies have to transpose the overall firm strategy in social media terms. They should be seen as part of the marketing strategy while the firm must bear in mind that social media is not just an additional marketing communication channel but an enrichment of the overall client relationship.

Compared to 'traditional' marketing strategies, social media strategies are much more vivid and reactive as they are fed by fresh customer feedback in real time. The firm's social media activity is to be seen as a continuous feedback-driven short-term process intended to achieve a long-term strategic marketing goal (which needs to be linked to a higher level strategic company objective).

“Our head of social media is the customer”, McDonalds Corporation

We designed a three-step approach to successfully build up and maintain a social media presence:

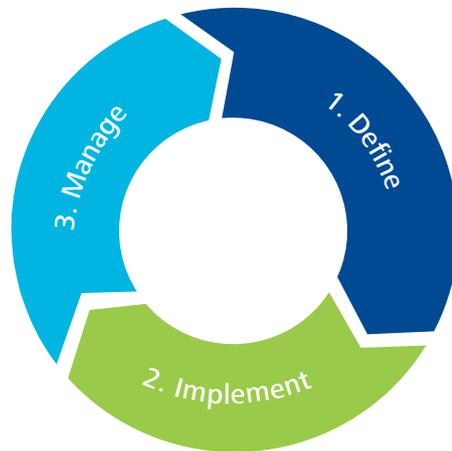
Phase 3: Manage

Threats:

- No interaction with clients
- No leveraging of available information
- No/inadequate impact analysis

Objectives:

- Create the content of your social media interaction
- Manage your social media strategy
- Measure the ROI
- Prepare and report a feedback



Phase 1. Define

Threats:

- Social media environment not in line with target audience
- The content published is not in line with the targeted positioning
- Key learnings from step 3 not taken into account

Objectives:

- Define target image/positioning
- Define target audience
- Define social media environment
- Choose degree of interactivity
- Feedback analysis from step 3

Phase 2. Implement

Threats:

- The wrong tools are used to get the message across

Objectives:

- Choose best content-channel mix
- Establish a timeline
- Provide help for governance
- Organise adequate operational resources to steer the project

This approach ensures a constant redefinition of the strategy and a solid feedback cycle—both are crucial in the fast-changing environment of social media. Strategy redefinition is mainly based on the feedback collected under point 3 of the approach. Therefore, the social media manager needs to have access to a comprehensive dashboard, which continuously indicates how to concretely rebalance social media actions.

Alongside the whole social media management process, strategy and model misspecification as well as poor interaction are risks which have to be managed appropriately by the firm. This can happen through the use of dashboards for misspecification risks or community managers for the interaction risk.

In general, social media strategies should be thought of as dynamic and reactive. Feedback cycles must therefore be in place, themselves being fed by a solid dashboard measuring all the relevant KPIs of the firm's social media strategy. Ultimately, this comes down to giving the customer increased power in defining the social media strategy of the firm, because it is the customer who reacts to the contents created by the firm and who creates their own content. 'Two-way communication' and 'interaction' are not only big marketing words but they make the customer play a key role and are the reason why, for social media, it is not possible to 'copy&paste' from other media or marketing strategies.



Today, the success and importance of social media for brand management can no longer be denied. Just like other brands, asset managers and fund promoters can profit from the main benefit of social media: direct interaction with customers. For the first time, they have the chance to eliminate the middleman, connect with the end investor and thereby increase retail fund sales. Well-managed social media activities still are a differentiation criterion from competitors, in the leading English-speaking countries and especially in slowly catching-up Europe and Asia. Appropriately managed, social media strategies are a high-potential, low-cost and low-risk opportunity for the fund industry.

The arena is open and calling for its heroes—gladiators, get ready for the fight!

“Sacred cows make very poor gladiators”, Nikki Giovanni, American poet and writer

To the point:

- Social media is a low-cost opportunity for asset managers to connect with their end investors and a powerful brand management tool
- U.S. and UK asset managers and fund promoters were the first to use social media, while other European players are still lagging behind
- The use of social media by asset managers and fund promoters bears legal risks which, managed appropriately, must not prevent the use of social media
- Measuring the return on investment of a social media strategy is difficult but the use of well-constructed dashboards helps
- Social media strategies must be linked to the overall company strategy, must constantly be updated and require continuous day-to-day management

Art-secured lending

Unlocking the liquidity of your clients' art collections

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Potential niche credit service line that private wealth managers can offer UHNWIs¹

Art is proving to be a 'beacon of optimism as [financial] markets tumble'²; it has ushered in an era of unprecedented opportunities for returns on investment, especially for Ultra-High-Net-Worth Individuals (UHNWIs) who are willing to consider turning their art assets into working financial assets. As an unleveraged real tangible asset, investment-grade art has historically performed better than conventional assets, including real estate (figure 1). This, in conjunction with the current economic environment marked by low interest rates and the continuous stellar performance of the art market, has increased the overall demand for art owners to use their art as collateral.

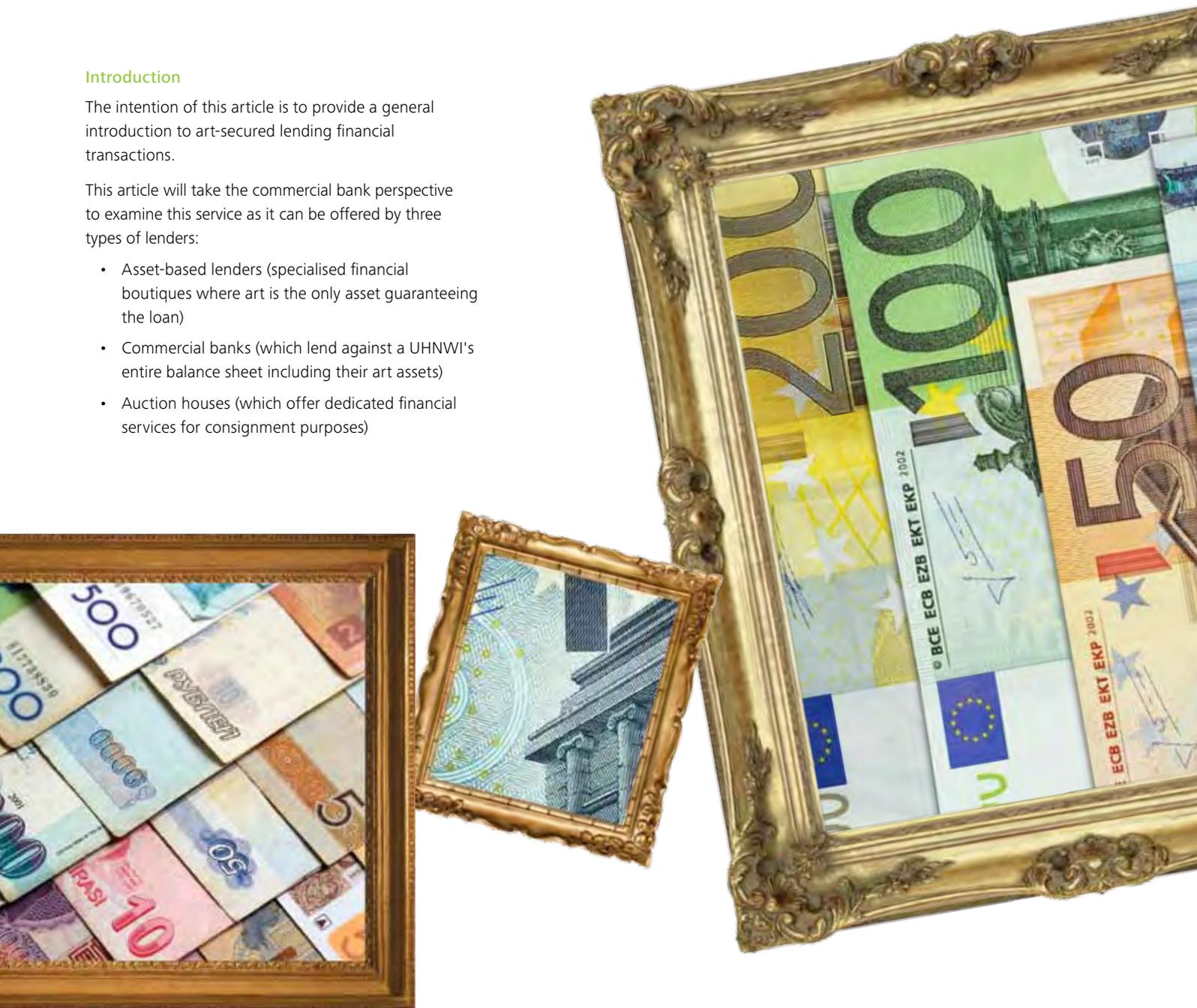


Introduction

The intention of this article is to provide a general introduction to art-secured lending financial transactions.

This article will take the commercial bank perspective to examine this service as it can be offered by three types of lenders:

- Asset-based lenders (specialised financial boutiques where art is the only asset guaranteeing the loan)
- Commercial banks (which lend against a UHNWI's entire balance sheet including their art assets)
- Auction houses (which offer dedicated financial services for consignment purposes)



¹ UHNWI is defined as an individual with more than US\$30 million in financial assets

² Thornton, S (2008): Is art the new gold? <http://www.telegraph.co.uk/culture/art/3561553/Sarah-Thornton-is-art-the-new-gold.html>

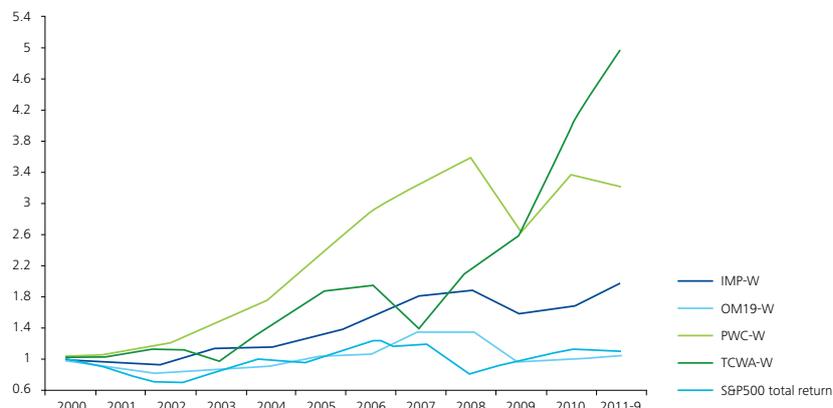
This article will start by analysing global market developments for art-secured lending and its inclusion in private wealth management services, and will also assess clients' willingness to invest in this niche financial service, in an effort to ascertain demand. It will then proceed to give a short overview of the practical implementation of the art-secured lending process and how it is being performed by current financial providers. It will conclude with the challenges and opportunities presented by art-secured lending.

What is art-secured lending?

Art-secured lending is a niche credit service aimed at UHNWIs who wish to unlock the liquidity out of their collection or art assets for investment or personal finance purposes. Having realised that an art piece can achieve liquidity without being sold, owners of expensive, museum-quality art are increasingly showing signs of interest in using their collections as collateral to obtain liquidity³. Despite all the current market volatility and related risk, the collateralisation of art has shown its potential within the wealth management industry, with its potential for profitability as a service provision and its application in relationship management for banks' top clients.

Figure 1. and table 1. Correlation, risk, return

Mei Moses® world collecting category art indexes vs. S&P 500 total return index 2000



Source: Mei Moses®

Table 1. Comparative performance table 2000-2011 September

Mei Moses® world collecting category indexes

	IMPMOD	OLM19C	Post war	Trad chinese	S&P total return
CAR	6.44%	0.71%	11.38%	15.82%	0.47%
STDEV	11.84%	15.18%	15.98%	27.51%	20.46%
CORR-S&P	0.11	0.03	0.02	-0.28	1.00

³ <http://www.bloomberg.com/news/2011-10-18/steinhardt-pledges-picassos-for-real-estate-as-art-loans-surge.html>

Brief overview: global market developments

A. U.S.: established market for commercial banks

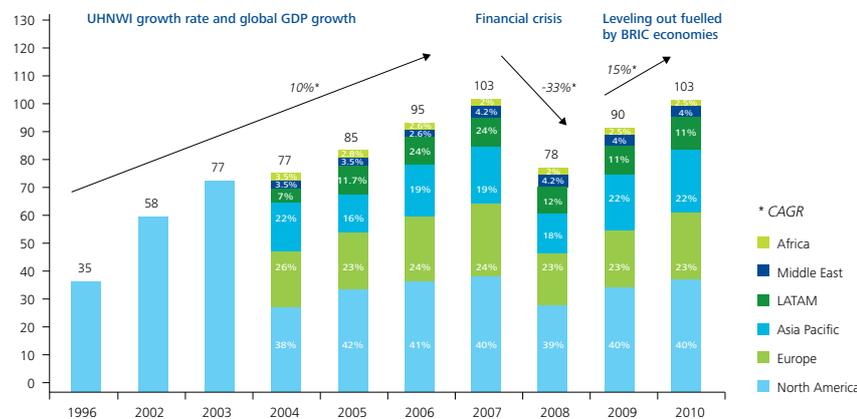
Currently estimated to be worth around US\$7 billion with an annual revenue base of half a billion, the growth in the U.S. art-secured lending market has coincided with the increased accumulation of hundreds of millions of dollars in art collections by ultra-high-net-worth individuals. More and more private wealth bankers are viewing these art collections as potential asset pools to secure significant loans⁴.

On the supply side there are established players in this market, with U.S. commercial banks such as Citigroup

(which established its operations in 1979), JP Morgan Chase and Bank of America. Recent developments have been made by UBS Wealth Management America in conjunction with Emigrant Bank to offer loans of up to US\$150 million collateralised by works of art, rare musical instruments and fine silver. On the demand side (clients/borrowers), there are tangible signs of UHNWIs' willingness and motivation to invest in this niche financial product and service. This is further confirmed by the fact that the targeted client base for this service is growing, with the U.S. consistently coming in as the top location for UHNWIs (figure 2).

Figure 2. UHNWIs, stable client base

The population of UHNWIs in 000s with geographic segmentation



The population of UHNWIs world wide grew 7.2% percent between 2002 and 2011 at an rate of 7.2 percent annually. Major downturn, post financial crisis effects- a decline 33% between 2007 and 2008, leveling out effect 2009, returned to pre-recession levels in 2011. Consistent ranges have been held by the leading locations of UHNWIs. North America (1). Europe (2) and Asia Pacific (3)

Favourable legal framework and number one location of UHNWIs

The strength of the U.S. market bears testimony to its attractive legal framework with respect to this service, with the uniform commercial code (UCC), article 9, offering advantages for both the lender and the borrower⁵. It enables the bank, as lender,

to legally file for possession of art assets after default and allows borrowers to let art remain in situ during the loan period⁶, as long as restrictions are complied with limiting when a piece can be moved (e.g., only following prior approval), where it can be moved to (only to approved locations—usually domestic, but sometimes to galleries or museums), and how it can be moved (only in an approved way)⁷.

4 Ferro. S (2012) Navigating the Art Loan Biz, A Surging Industry Attracting Both Big Banks and 'Loan-to-Own' Sharks, 4 April 2012 <http://www.artinfo.com/news/story/797602/navigating-the-art-loan-biz-a-surging-industry-attracting-both-big-banks-and-loan-to-own-sharks>
 Notable figures: Michael Steinhardt, the former hedge-fund manager who has spent at least US\$200 million on fine art, is using part of the collection to secure low-cost funding for his latest real estate venture

5 Ferro. S (2012) Navigating the Art Loan Biz, A Surging Industry Attracting Both Big Banks and 'Loan-to-Own' Sharks, 4 April 2012 <http://www.artinfo.com/news/story/797602/navigating-the-art-loan-biz-a-surging-industry-attracting-both-big-banks-and-loan-to-own-sharks>

6 Herrick's Law Art as Collateral, 25 May 2010, New York

7 <http://artlawteam.com/art-can-be-collateral-loans-based-on-works-of-art/>



B. EU: growing market

The EU provides a plausible market opportunity for art-secured lending. This is primarily due to the following reasons:

- **UHNWIs are switching to tangible assets (art assets):** EU-resident UHNWIs are showing increased interest in tangible assets as part of their general move toward 'simplicity, familiarity and tangibility'
- **High art-asset allocation within Europe:** a recent Barclays report entitled 'Profit or Pleasure? Exploring the Motivations Behind Treasure Trends' demonstrated that art, pictures and paintings' ranked as the top three most popular treasure types (Ireland: 10%; UK: 7%; Spain: 14%; Switzerland: 6%). This provides the opportunity to turning these art assets into working financial assets
- **Decreasing levels of liquidity due to higher cost of borrowing:** EU-based banks have reduced loans to businesses and consumers while they shore up their capital to guard against sovereign-debt exposure⁸

Developments in Europe have also been characterised by U.S. affiliates looking for expansion opportunities

⁸ Eurozone debt crisis had far-reaching effects in 2011, World Wealth Report, Capgemini & RBC 2012, p 12

Market developments

Developments in Europe have also been characterised by U.S. affiliates looking for expansion opportunities. For instance; Emigrant Bank currently serves the UK and Continental European market with transactions based in USD and similar borrower rates, all from their NY office⁹. Deutsche Bank Private Wealth Management is also a significant player offering art-secured lending services and has even extended its ability to lend on multiple asset classes from residential and commercial real estate to yachts. Other European players include ABN AMRO Luxembourg.

C. China: market opportunity—number one art market

The Chinese art market has become a force to be reckoned with. In early 2012, the European Fine Art Foundation (TEFAF) reported that China (including Hong Kong) has overtaken the U.S. as the world's largest market for art and antiques. According to the TEFAF report, China's share of the global art market rose from 23% in 2010 to 30% in 2011¹⁰, pushing the U.S. into second place, with 29%. This position as the leading art market signals China's unquenchable thirst for art investment and collecting, and the indisputable speed with which it reached this level. Even though the Chinese figures have been subject to speculation, there is no denying the importance of China in the art market today¹¹.

Government incentives to push cultural policy

The central government and the culture industry have set a goal of accelerating 'cultural development and prosperity' after the Sixth Plenary Session of the Chinese Communist Party's 17th Central Committee. This plan will allow financial institutions to accept verified artworks and other collectible items as collateral for bank loans to cultural enterprises.

Want Daily reported that 'the government has started a plan to establish a complete financial industrial chain for valuable collectibles by enhancing product verification and certification, stepping up manpower training, offering collateral loans and other financial instruments.'

Banks will be more willing to offer loans based on the true market value of the items after their human capital develops the adequate knowledge and gains 'art evaluation certificates' (government-accredited art valuation certificates). This will in turn help set up a capital market of artwork and collectibles with true value¹².

Global trends in private wealth management pushing for more tailored services to (U)HNWIs—pressure on profitability

With increased pressure on profitability in the private banking sector¹³, the acquisition and retention of HNWI and UHNWI clients is a central issue facing wealth management services. Given the business opportunities afforded by this client segment, private banks seek to closely tailor their services to UHNWIs and incorporate their passion investments including art (figure 3). Such services include art-secured lending, in other words the use of art as collateral for lending purposes.

9 *Emigrant Bank and its European activities: in its EU based transactions Emigrant Bank take possession of the artworks by placing them into a Freeport to ensure control over collateral, or into a bonded warehouse. It has agreements with UHNWIs/private individuals, museums and galleries. Museums agree on their lien agreement have used the Freeport-non possession agreement. Borrowers are placing loans in US dollars and hedge against currency risk, with effective asset portfolio management. Phone interview between Deloitte Art & Finance and Emigrant Fine Art, Andrew Augenblick. 11 June 2012*

10 *The International Art Market in 2011: Observations on the Art Trade over 25 Years, commissioned by TEFAF Maastricht, published 16 March 2012, accessed through the World Wealth Report, Capgemini & RBC 2012, p. 24*

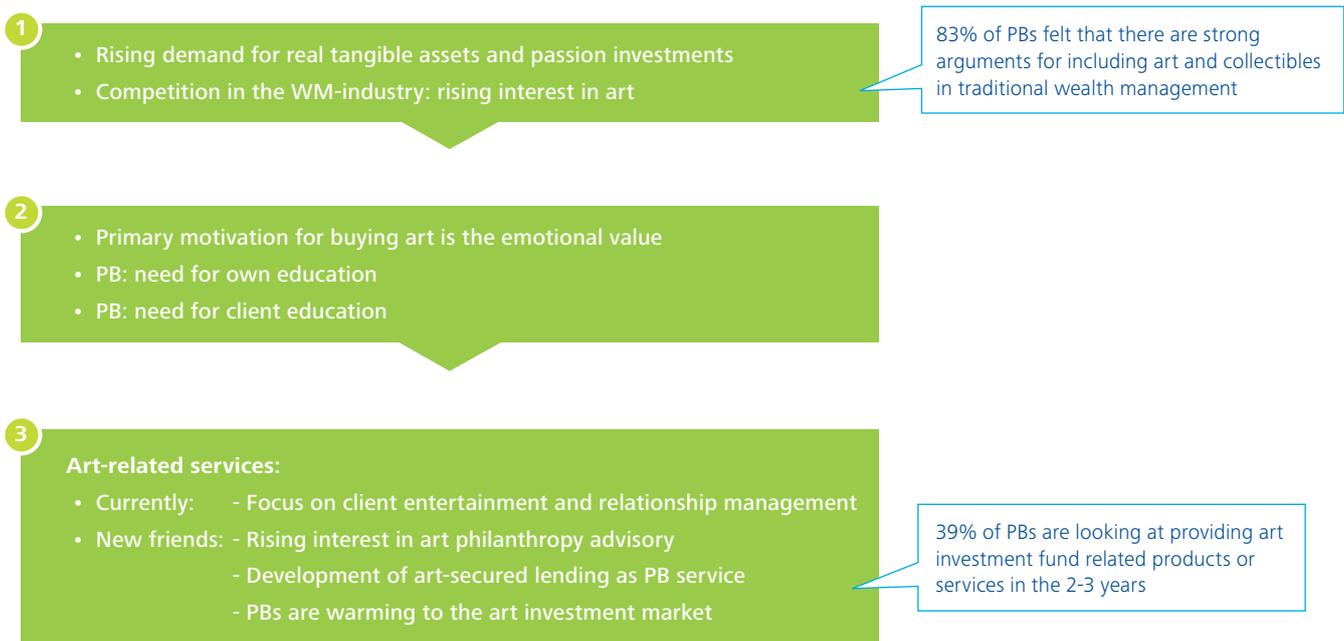
11 *What Chinese collectors are really buying, Georgina Adam. Market, Issue 235, May 2012, The Art Newspaper*

12 http://www.australianbusinessforum.com.au/blog/ACBW_Feature_Articles/post/Chinese_banks_to_offer_collateral_loans_on_art_collections/

13 *Wealth management has fundamental strengths as a business; costs have risen faster than the growth in revenues in recent years, World Wealth Report, Capgemini & RBC 2012, p. 26*

Figure 3. Art and private wealth management—present situation

Deloitte Luxembourg Private Wealth research



Source: Deloitte Luxembourg and ArtTactic Art & Finance Report 2011

Increase in client bargaining power

Private wealth clients’ bargaining power has increased significantly due to their readiness to switch management and palpable demand for individualised, tailored services. There is now a significant shift from passive client-relationship management to more intimate, longer-term, value-added client relationships. The head of Private Client Services at Deloitte, Tony Cohen, said that *"while diversification, performance and efficiency are the common influencers on the choice of wealth manager by a high-net- worth*

individual, wealth managers need to go above and beyond this and consider the detailed needs of each client¹⁴." Taking this into account, the private wealth industry is pushing for differentiation, whereby a 'best versus big' strategy will prevail with niche services such as art-secured lending. Therefore the commitment to differentiate and involve art within the private wealth service offering requires an educational commitment from both the banks for their private wealth teams and from clients to encourage their passions to be carried on into future generations.

¹⁴ *Wealth managers losing client trust .Research finds some wealth managers have grown at the expense of client relationships. Deloitte UK industry report http://www.deloitte.com/view/en_GB/uk/industries/financial-services/bcc0fbd6ea1fb110VgnVCM100000ba42f00aRCRD.htm*

What are the benefits of this service?

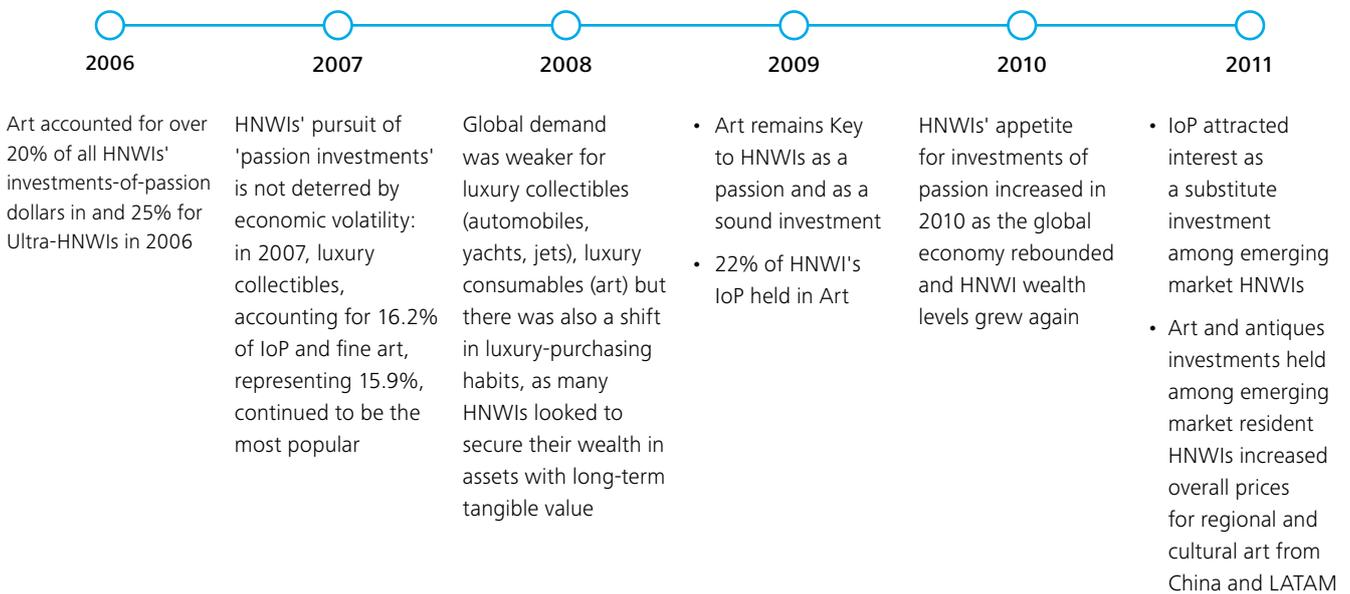
There are several advantages to providing an art-secured lending service. Firstly, it helps in gaining and nurturing relationships with UHNWIs and offers liquidity/cash flow, which has resonance with the current UHNWI client base and the younger generations. By offering this service, it allows the bank to protect itself against low switching costs and ensure longevity in its asset management relationships. For the bank entity launching this service, it enables the entity to become a competence centre for the overall group. To conclude, this service would be a sustainable, client-based initiative, capitalising on a bank's credit expertise and wealth management activities.

Who is it aimed at?

Advantages of this service for UHNWIs

UHNWIs view investments in art as alternative vehicles for preserving and enhancing their capital over time, diversifying their portfolio exposure or even capturing short-term speculative gains and reaping rewards from the low correlation to global financial markets¹⁵. Capgemini and its World Wealth reports have demonstrated that the UHNWIs surveyed showed a consistent interest in investments of passion (IoP) between 2006 and 2011 (figure 4).

Investor sentiment: Amidst volatility - increased buying of investments of passion (IoP)



Note: Qualitative analysis based capgemini in association with RBC/Merrill Lynch reports: 2007-2012

¹⁵ http://www.deloitte.com/view/en_LU/lu/industries/ims/cba88bed57912210VgnVCM100000ba42f00aRCRD.htm

Considering this investor sentiment, art-secured lending equips this type of client with more financial flexibility by offering the opportunity to change a passion investment into a working asset. Art collateral alone is not the sole deciding factor for clients using this service. UHNWIs' motivations for using this niche financial service include the following: 'cashing in' on the increased value of a work of art without selling it, gaining liquidity without paying the capital gains tax of an artwork sale, using art-secured loans to acquire other artworks (keeping their art collecting activities separate from their other business activities) and using art loans to secure real estate development¹⁶.

Further motivations include financing divorce, asset diversification, life insurance premium financing, charitable donations and annual exclusion transfers (gift transfers)¹⁷, etc. Legally speaking, clients prefer for artworks to remain in situ, in their homes or personal collections, and would generally seek to avoid the transfer of their art pieces for storage with the banking facilities.

How does it work?

Art-secured lending—basic transaction overview

In a basic transaction, art-secured lending is short-term (6 months to 5 years) and collateralised by 'museum-quality' fine art that is both marketable and has a high fair market valuation (FMV), i.e. a high price for which similar works of art have sold at auction is generally accepted to be a reasonable estimate of fair market value. As with all other asset classes, the prudent approach implies risk diversification and proper allocation of that risk both with respect to a particular loan, and within the lender's total loan portfolio.

Additionally, full recourse lending is primarily pursued by commercial banks, meaning that the banks lend against a customer's entire balance sheet, including equities and real estate, rather than just pledging a few museum-quality pieces of art. Borrower rates are typically fixed at a spread between 2% to 5% above the LIBOR rate¹⁸.

A variety of financing options are offered, including term loans (which become due on a specific date) and revolving loans or lines of credit (which allow money to be paid back and re-borrowed during the life of the loan). These loans generally contain net-worth covenants, requirements for financial reporting on an assigned basis, and a requirement that the lender be notified before any piece of art collateral is moved or sold¹⁹.

Typically, a loan-to-value ratio of 50% is usually utilised, as the ratio is used to establish the initial loan amount and to act as a permanent borrowing base, where the borrower will be required to either pay down the loan or encumber additional art (or other collateral) if the ratio ever exceeds the maximum allowed.

Art collateral alone is not the sole deciding factor for clients using this service

16 Ferro. S (2012). *Navigating the Art Loan Biz, A Surging Industry Attracting Both Big Banks and 'Loan-to-Own' Sharks*, 4 April 2012 <http://www.artinfo.com/news/story/797602/navigating-the-art-loan-biz-a-surging-industry-attracting-both-big-banks-and-loan-to-own-sharks>

17 McAndrew. C (2010). *Fine Art and High Finance: Expert Advice on the Economics of Ownership*, Chapter 5, and *Art Banking—the origins of Art Finance*, motivations for art-based lending, co-written with Suzanne Gyorgy

-'Annual Exclusion' definition: the amount of money that may be transferred by gift from one person to another each year without incurring a gift tax or affecting the unified credit. This amount can be transferred in the form of cash or other assets

18 *Ibid*, based on Citibank's borrower rates offered

19 McAndrew. C (2010). *Fine Art and High Finance: Expert Advice on the Economics of Ownership*, Chapter 5, and *Art Banking—the origins of Art Finance*, motivations for art-based lending, co-written with Suzanne Gyorgy

Navigating the challenges

Traditionally, commercial banks may have had general aversion against using art assets on their balance sheet, due to being constrained by internal credit-granting philosophies, lack of financial knowledge about fine art and its asset quality, and lack of legal understanding pertaining to holding and storing art assets. But the central challenge faced by each commercial bank offering the art-secured lending facility has been the inability to correctly assess the risk from changes in the price movements of Art. This was reflected in our Deloitte and Art Tactic 2011 report, whereby valuation of an art asset was considered a central challenge for several financial institutions²⁰.



²⁰ 78% of wealth managers said that the problem of valuation and difficulties in assessing the downside risks were the biggest hurdles against offering these types of loans, http://www.deloitte.com/view/en_LU/lu/industries/art-and-finance/publications-research/75fdf9191b4f3310VgnVCM2000001b56f00aRCRD.htm

There is now a significant shift from passive client-relationship management to more intimate, longer-term, value-added client relationships

Valuation of art assets: industry practitioners' perspective

Leading service providers approach art valuation in various ways. For instance, Citibank appraises or values art through a combination of art market indices, auction data and an external expert²¹. When collateralising, the credit facility is almost never secured

by a single work. To be prudent, the bulk of the secured portfolio should be pieces that have historically held stable value or appreciated predictably over the long term, namely in 'blue-chip' art categories such as Classical Modernism, Impressionists, Old Masters and Post War Contemporary Art. Regional Art in general is avoided and viewed as too speculative to act as an underlying asset²². Jeremy Eckstein from ArtBanc, the art and finance advisory, highlighted their art valuation approach, saying *"we use art expertise and superimpose on that, some underlying empirical valuation, (auction comparables are generally used), in order to reinforce what the experts are saying and by blending these two techniques, you achieve a more informed valuation of the art piece"*.



Conclusion

Whilst the use of art as collateral has not been a traditional method by which lenders have chosen to secure lending, private banking business practices are changing to keep up with emerging opportunities, and new ways of generating income on the security of works of art is being considered by some major lenders. With the right due diligence framework and valuation process combined with effective, carefully drafted loan and security documentation, it certainly would be possible to offer this niche lending service to art collector UHNWIs. Therefore, by providing a service that can be both profitable and client-centric in nature, differentiate your private wealth offering.

To summarise, education of both the client and lender is needed on the underwriting of an art asset and its related processes, as, according to Andy Augenblick, president of Emigrant Bank Fine Art Finance, 'investment into human and intellectual capital is an imperative before lending financial capital'.

To the point:

Why art-secured lending? A tailored service to respond to UHNWIs' needs.

Trends:

- Private bank trends: pressure on profitability, retaining and gaining new UHNWI clients, need to differentiate their range of services
- Art represents a sizable portion of UHNWIs' wealth
- New art collectors with new behaviour willing to turn art into a working asset
- Growing targeted client base: increasing number of UHNWIs worldwide and their appreciation for art as an asset class continues to develop
- Sustainable and growing market: established banking industry participants in EU and U.S. offering art-secured lending to their UHNWI clients and developments in China
- Art has become a more measureable and manageable financial asset

21 McAndrew. C (2010). *Fine Art and High Finance: Expert Advice on the Economics of Ownership, Chapter 5, and Art Banking — the origins of Art Finance, motivations for art-based lending, co-written with Suzanne Gyorgy...*

22 Citi Family Office, *Art Advisory Service, New York pdf*



Passing the baton

Hedge fund succession planning

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Do you want the hedge fund you established to continue in perpetuity? Are you willing to cede influence and a sizeable ownership stake? Do you believe a new leader can steer the ship effectively in your absence?

Legacy: fostering a new generation of leadership

Are you willing to keep much of your wealth co-invested after you have given up control? For succession planning to work, founders need to genuinely want succession to take place, recognise they are replaceable, and keep significant skin in a game controlled by others.

Succession should be a seamless transition. While it is never a non-event, it should ideally have minimal impact on investment performance, assets under management, employee turnover and corporate culture. This task is daunting because of the divergent perspectives of key stakeholders. Investors typically view succession through the negative lens of key person risk, explicitly negotiating protections like key person provisions, insurance, or redemption rights. Their natural inclinations are often to redeem first, then ask questions later. Meanwhile, portfolio managers and other employees might feel overlooked during a leadership transition and seek employment elsewhere. However, a founding principal can think of succession as a once-in-a-lifetime opportunity to perpetuate a franchise, professional legacy, economic interest and income stream.

Succession planning addresses two main considerations: ownership and governance. Industry luminaries have approached these topics in various ways. From an ownership standpoint, Michael Steinhardt liquidated Steinhardt Partners upon retirement¹, whereas Stanley Druckenmiller transitioned Duquesne Capital Management into a family office². Some founders monetise equity through initial public offerings or by selling stakes to strategic or financial partners, whereas others transfer equity to key employees.

In addition to the ownership question, a founder needs to determine how decisions will be made under new leadership. A founder may cede authority to one successor or disperse it among discrete management committees. Additionally, a founder should reflect on how much influence to retain after retirement. This might range from a formal advisory presence, to an informal mentoring role, to a completely hands-off approach.

If external talent is selected, it is critical to leave plenty of time to integrate this hire into the hedge fund's culture

Succession planning is not a paint-by-numbers activity. A quant fund's succession plan likely differs from an activist investor's. However, there is one vital ingredient with no substitute: starting the process early. Even emerging managers can think broadly about whether they aspire to build more than single-generation franchises, in which case, they could begin planting the seeds for a smooth succession from day one. Succession planning is a fluid process that evolves over time.

¹ Liz Moyer, 'A Tree of Wisdom,' *Forbes*, June 13, 2006 <http://www.forbes.com/2006/06/12/wisdom-tree-etfs-cx_lm_0613etf.html>

² Katherine Burton, 'Druckenmiller Calls It Quits After 30 Years as Job Gets Tougher,' *Bloomberg*, August 18, 2010 <<http://www.bloomberg.com/news/2010-08-18/druckenmiller-calls-it-quits-after-30-years-as-hedge-fund-job-gets-tougher.html>>

Ten myths of hedge fund succession planning

1. Succession planning is not a priority yet. We will get around to it eventually
2. We do not need to plan for succession because 'our team knows' how to handle a leadership transition
3. Investment performance is everything. As long as we generate alpha, succession will work itself out
4. Discussing succession publicly will spook investors and imply the founder already has one foot out the door
5. Succession planning is simply a check-the-box activity to appease investors
6. Founder knows best. There is no need to seek input from employees, investors, or outside advisers when planning for succession
7. A succession plan should be sufficiently vague to allow for flexibility and subjective interpretation
8. Only SEC-registered, large, or established hedge funds need to plan for a founder's succession
9. Signed, sealed, and delivered. There is no reason to refresh a succession plan after it has been created
10. There is no risk that anyone wants to sabotage our succession plan

Selection: identifying the right successor

What qualities should you look for in a prospective successor? What is your 'plan B' if you can't find the ideal candidate? Should you promote internal talent or instead hire externally? What role does cultural fit play in the selection process?

Identifying a hedge fund leader differs from the boilerplate approach common to many other industries. In a classic succession model, a pool of high-performing leadership talent is methodically identified in a process overseen by a company's Board. However, this traditional approach is often unrealistic when it comes to hedge funds because a founding principal's shoes can be exceptionally difficult to fill.

A successful hedge fund leader is a rare breed. This individual needs a broad range of skills tailored to a hedge fund's investment strategy, talent pool, investor base and culture. In collaboration with business psychologist Kaisen Consulting*, we developed a framework to help the industry identify the most critical qualities a hedge fund leader generally needs. We believe two demonstrable capabilities represent the essence of hedge fund leadership: strategic execution and adaptive influencing.

- **Strategic execution** relates to the yin and yang qualities of determining a strategic vision and then delivering upon it. Like a shark smelling blood, a hedge fund leader relentlessly identifies and exploits opportunities by allocating capital towards 'white space' others may miss
- **Adaptive influencing** helps a hedge fund leader build a team of high-performing employees, investors, and other business partners. A hedge fund leader inspires, respects, and garners support from stakeholders in collaborative pursuit of shared goals

* Kaisen Consulting has benchmarked leadership qualities of 15,000 global leaders across industries

Ideally the perfect candidate is waiting patiently in the founder's shadow, prepared to take over at a moment's notice. But this utopian scenario is atypical.

If the right candidate cannot be found, a successor could be created instead. A founder can groom a high-potential candidate who has the necessary raw materials to become a hedge fund leader. We believe the following three qualities are tell-tale indicators of leadership potential:

- **Intellectual power and flexibility** allows a hedge fund leader to think broadly and quickly enough to conceptualise complex data into insights that lead to value-creating decisions
- **Motivational drive** is a sense of mental toughness. It enables a hedge fund leader to help employees resiliently adapt to adversity
- **Interpersonal insight** is a natural ability to read people well. When interacting with employees, investors, and other stakeholders, a hedge fund leader actively listens in a way that satisfies the needs of others

A candidate possessing these three qualities probably has the horsepower needed to succeed. But there is one more crucial aspect to consider carefully during the selection process: cultural fit.

Identifying a hedge fund leader differs from the boilerplate approach common to many other industries



A founder can groom a high-potential candidate who has the necessary raw materials to become a hedge fund leader

One common approach industry-wide is to appoint a longstanding internal portfolio manager as heir-apparent. This investment professional could be a strong cultural fit, but might need leadership coaching. Alternatively, a proven leader can be hired externally and eased into the hedge fund's unique culture. If external talent is selected, it is critical to leave plenty of time to integrate this hire into the hedge fund's culture.

Grooming: sponsoring the successor among key stakeholders

Now that you have identified your successor, how will you prepare this individual to walk in your shoes? Why is the grooming process so important?

Grooming is the most complex and time-consuming step of the succession planning process for two reasons: 1) first class hedge fund talent is rare, highly incentivised, and generally mobile; and 2) money management is a relationship business built on accumulated trust. Grooming helps a successor refine leadership skills and build relationships with key stakeholders.

Because of the high stakes involved, a founding principal should directly sponsor the grooming process, rather than delegating this task. For instance, a successor can shadow a founder to learn the role's ins-and-outs from the ground up. As the successor builds credibility, the founder gradually cedes decision-making authority.

Figure 1 highlights specific strategies that can be employed to ease a leadership transition in the eyes of employees and investors.

Figure 1. A selection of grooming strategies

Building employee loyalty	Establishing investor credibility
<p>Engagement:</p> <ul style="list-style-type: none"> • Communicate openly with employees so they know where their career trajectories stand • Engage key employees early on in the succession planning process <p>Incentivisation:</p> <ul style="list-style-type: none"> • Incentivise successor generously as an owner. Align long term interest (i.e., using vesting provisions and restrictive covenants) • Incentivise key employees to support leadership transition 	<p>Communication:</p> <ul style="list-style-type: none"> • Actively listen to investor needs and gradually warm investors up to succession plan • Raise profiles of successor and other key executives through direct investor interaction (e.g., investor meetings, calls, letters) <p>Governance:</p> <ul style="list-style-type: none"> • Clearly define governance framework over investments, operations, risk and other key business activities • Create a new fund run independently from founder. This can help allay investor concerns about the continuity of alpha generation after founder departs



Timing: executing succession at the right time

While a founder remains in charge, this entrepreneur typically has a laser-like focus on running the business. Succession planning is often stuck at the bottom of a founder's to-do list until it is too late. Even though a succession event may not take place anytime soon, succession planning should be a priority. Those who begin planning for succession early and revisit the topic regularly are better prepared to avoid unintended consequences.

It is not always possible to precisely time a succession, especially in cases of unplanned death, disability, or retirement. However, correctly timing a succession can potentially make or break a founder's legacy. If a founding principal transitions out of the limelight too soon, investors or employees may not have fully bought into the succession. If planning begins too late, the founder risks running out of time and missing the window of opportunity.

The founder is best placed to recognise when key stakeholders – employees, investors, and the successor – are ready for a leadership transition. Once the timing is right, the founder hands over the reins.

We believe two demonstrable capabilities represent the essence of hedge fund leadership: strategic execution and adaptive influencing



Leaving on a high note

Hedge fund succession planning is a fragile process. Even the best-laid plan can be thwarted by a small group of investors or employees. The critical challenge is balancing a complex set of competing stakeholder priorities.

Not surprisingly, most hedge funds avoid publicly discussing succession plans. However, once a credible succession plan has been developed, a hedge fund may want to discuss it more openly. Over time, transparency about succession might distinguish a lasting hedge fund franchise from its competitors.

In anticipation of an eventual leadership hand-off, succession planning can help a founder leave on a high note when turning over a hedge fund's baton to a new leader.

It is not always possible to precisely time a succession, especially in cases of unplanned death, disability, or retirement

Appendix: additional considerations of a hedge fund succession plan

A comprehensive succession plan extends far beyond the single dimension of replacing a founding principal focused on in this report. From a human capital perspective, a succession plan should encompass all key investment and non-investment professionals. In addition to human capital considerations, succession preparedness is a multidimensional process linked to tax, legal, financial and other specialisations.

To the point:

- Hedge fund succession planning is the delicate process of balancing priorities among investors, employees and a founder, with respect to ownership and governance issues related to a leadership transition
- While succession planning typically includes the consideration of financial, tax, legal, and other specialised disciplines, human capital decisions can particularly make or break a succession plan
- If the right successor cannot be found, a founder can instead create a future leader by grooming a high-potential candidate who exhibits leadership potential and cultural alignment
- Various strategies can be implemented to help a prospective successor build employee loyalty and establish investor credibility in advance of a succession event
- To avoid unintended consequences, a hedge fund should start preparing for succession early in its lifecycle and revisit the topic systematically

Legal and compliance

- Regulatory requirements
- Succession triggers
- Shareholder agreements
- Voting control
- Operating agreements

Management

- Governance
- Culture
- Business strategy

Financial and tax

- Exit strategy
- Buy-sell agreement
- Business valuation
- Estate planning
- Life and disability insurance

Investor relations

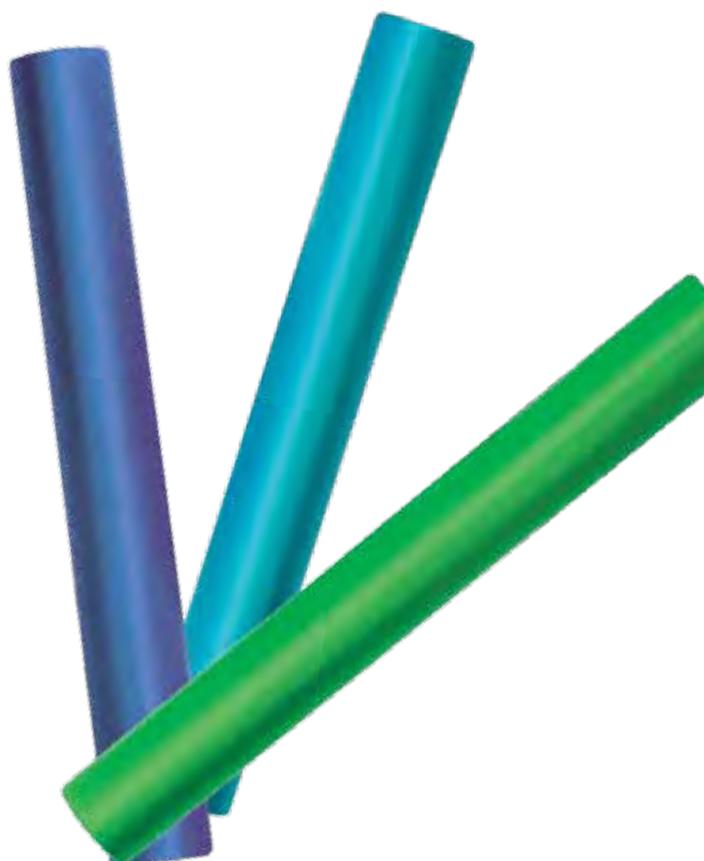
- Investor communication
- Marketing

Human Capital

- Successor identification
- Ownership
- Compensation

Operations

- Intellectual property
- Brand
- Contingency planning



Internal audit—the need for a risk guardian in asset management companies

Heightened risk oversight expectations in the asset management industry

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High profile fraud schemes, insufficient risk management practices, concerns about valuation and pricing, and an increasingly competitive economic climate have led to heightened regulatory and investor scrutiny of asset management organisations all across the globe.

Growing market uncertainty, combined with pressure to meet investor expectations, comply with a fast evolving regulatory landscape and operate a lean, efficient organisation, has resulted in the need for asset management firms to re-evaluate their business objectives and focus on effectively managing and overseeing the broad range of strategic, market, credit, liquidity, operational, reputational and compliance risks they are facing.

As asset management firms are reshaping the way they manage risks and revising their risk governance models, there is an increased focus on timely and

clear communication with stakeholders (e.g. investors, regulators or counterparties) regarding how risks are being addressed.

More specifically, regulators' demand for enhanced risk governance and risk management accountability at board and executive level has reached unprecedented levels and is still intensifying.

To fulfil their increasing responsibilities, board members and executives of asset management companies are more than ever relying upon high performing internal audit functions to objectively and proactively identify and help address risk areas before they become an issue.

Asset managers are indeed looking for solutions to pressing issues including:

- Loss of trust and confidence by the investment community
- Increased investor due diligence and need for transparency over asset managers
- Heightened focus on corporate governance by investors and regulators
- Additional focus on internal controls and governance resulting from regulatory and contractual obligations (e.g. third-party arrangements, operating fund agreements, etc.), financial reporting controls
- Increased complexity of financial products, instruments and infrastructure
- Operating with reduced resources (doing more with less)
- Globalisation/outsourcing/off-shoring/technology reliance increasing risk profiles
- Advances in technology affecting the scope of internal audit
- Enhanced use of automated and model-based risk management processes to monitor risk more dynamically
- Increased concerns over valuation and existence of investments



Risk and control challenges

Traditionally, asset managers have primarily focused on investment risk and portfolio analysis. However, this myopic view is changing; the current market and regulatory conditions are placing significant demands on asset management firms and forcing them to assess a broader risk spectrum across the organisation. As such, asset managers are now dealing with a broader range of risk and control challenges, including for instance:

- **Increased regulatory requirements:** asset managers used to delegate to their compliance officer the responsibility for conducting evaluations of the effectiveness of compliance policies and procedures within the organisation without having technical risk and control-oriented knowledge required for the position. As a result, many asset managers are reaching out to their internal audit function to assist in the evaluation of the design of the firm's financial, operational and compliance controls as well as in testing the effectiveness of these controls, and, importantly, harmonising and coordinating the various evaluation efforts to minimise overlap and duplication

Traditionally, asset managers have primarily focused on investment risk and portfolio analysis

- **Enhanced fiduciary expectations:** asset management organisations must also address the enhanced fiduciary expectations of board members, clients, executive management and regulators. Executives are looking for more summaries of risk and control information; board members are increasing their requests to executive management to provide them with greater detail of risk and control information and regulators have significantly heightened their expectations too
- **New and greater operational and compliance risks:** as the business of asset management continues to evolve, organisations must confront new and increased sources of risk. For example, off-shoring and outsourcing have extended asset managers' enterprises to include new players and new geographies, which have further stressed and stretched the capabilities and the resources needed for effective oversight. Therefore, the need for comprehensive enterprise risk management practices continues to increase. The challenge then becomes how asset managers can address these risks without creating a complex, disorganised governance structure. The desired state for governance risk and compliance is an enterprise-wide approach which overtakes transparency and efficiency

The rewards of achieving this desired state can provide a competitive advantage and enable asset managers to improve their ability to prevent, detect, correct and escalate risk issues on a timely basis.

Internal audit can play an important role in looking broadly at risk and helping to build a more risk-intelligent organisation. In addition to their traditional role of validation, internal auditors can take a more active stance in identifying and assessing risk in strategic decisions and business processes across the enterprise.



The expanded role of internal audit

As a result of the changes in the asset management industry, the internal audit's role in organisations is expanding. In an effort to better manage the risks facing their organisations, asset management firms are looking to their internal audit functions to add value to their management governance structure.

Initially, internal auditing was an objective assurance which evolved as a consulting activity designed to add value and improve an organisation's operations. When designed, staffed and equipped adequately, an internal audit function may indeed tremendously assist an organisation in accomplishing its strategic objectives by bringing a systematic, disciplined approach to evaluating and improving the effectiveness of risk management, control and governance processes.

This core function provides assertive leadership which enhances the organisation's commitment to robust risk management and an internal control framework.

An effective partnership with executive management and board members allows internal audit to assist them in fulfilling their broad duties and responsibilities in today's fast changing environment.

Aligning the internal audit function's role with the firm's business strategy can improve risk management in a number of ways:

- **Comprehensive risk assessments:** asset managers are relying on their internal audit functions to conduct robust risk assessments. They are asking them to examine the entire organisation, not only so as to develop their internal audit plan but also for the benefit of other risk assurance functions (e.g. risk management and compliance) in the firm
- **Third-party compliance:** with the growing reliance on third parties through outsourcing, asset managers are asking internal auditors to examine the controls employed by vendors and business partners

- **New-business initiatives:** internal auditors are increasingly playing a role in constructively challenging product development and business expansion so that appropriate controls are in place from the start
- **Risk-based auditing:** with the limited resources available to asset managers, the internal audit function has to be in the right place, at the right time and doing the right things. Proper risk-based auditing, in addition to comprehensive risk assessment, is critical
- **Involvement in technology:** in many asset management firms, internal audit is expanding its role in the technology space by addressing security and privacy, investment compliance, trade operations and settlement, vulnerability assessment and intrusion testing. Internal auditors are also utilising technology to support their organisation's data analysis and forensic testing efforts
- **Heighten visibility:** internal audit can act as an objective risk and control evaluator for the board and executive management through direct reporting to the audit committee and through an administrative relationship with executive management
- **Champion governance activities:** with the growing demand for enhanced and increased governance activities, firms are increasingly asking internal audit to help with risk management integration by facilitating the connection of various activities





Internal audit plays a major role in the corporate governance framework by improving overall performance and operating efficiency.

In today's environment, asset management firms go beyond traditional fundamentals and add tangible value so as to elevate internal audit to an even more strategic and productive role within corporate governance. This independent function helps management face the serious dilemma in striking a balance between complying with regulations, managing costs and garnering benefits from an improved internal control environment in order to attain and sustain compliance.

The internal audit function is therefore increasingly recognised as a fundamental component of a healthy corporate governance structure, from the point of view of improving the level of transparency and reliability in relationships with investors according to internationally accepted quality standards.

Internal audit in response to current market conditions

In view of the current market conditions faced by the asset management industry, internal audit functions are more than ever expected to assist their organisations in addressing a broader range of critical issues raised by regulatory changes, competition, globalisation, advances in technology and the changing demands of clients.

Market exposure

By reporting market risk exposure on a periodic basis, the asset management industry ensures compliance with prospectus requirements and appropriate reactions to market changes.

When markets are volatile, market risk increases, and determining the effect this has on the securities held becomes more complex. Market exposure is determined by myriad factors, including the terms under which the securities are held, the type of securities held, the term to maturity of those assets and the prevailing market conditions for the asset type held. By having a view on where investments lie, an asset manager can appropriately react to any investor queries raised over the profile of the fund.

The internal audit function can intervene by examining the processes in place for reporting market risk, determining the appropriateness of these in light of market conditions, verifying the accuracy of the exposures being reported and suggesting improvements to ensure a robust approach in this area.

"In today's fast changing asset management industry environment, there is an increased focus on timely and clear communications with stakeholders (e.g. investors, regulators or counterparties) regarding how risks are being managed and overseen. Global regulations are growing in volume and complexity, increasing the importance of compliance and risk management. The internal audit function has evolved to face these new requirements"

When markets are volatile, market risk increases, and determining the effect this has on the securities held becomes more complex

Asset valuation

Choosing the correct asset valuation methodology is a challenge faced by all asset managers. The method by which assets are valued is determined by a number of variables, such as the underlying asset itself, the reason the asset is held, regulatory guidance and prevailing market conditions. Once the method of valuation has been selected, it is important to ensure that adequate controls are in place to accurately value the assets using this methodology. This could include ensuring the accurate capture of asset cash flows, or alternatively ensuring that up-to-date and accurate market information is obtained. Furthermore, having appropriate systems and controls in place will help to manage valuation difficulties and guard against questionable prices going unidentified.

“To fulfil their increasing responsibilities, board members and executive management need to rely upon high performing internal audit functions to objectively and proactively identify and help address risk areas before they become an issue”

As a solution to the asset valuation issue, internal audit may look at the assets held and review selected valuation methodologies to ensure that they comply with best practice and regulatory guidance. It will then look at the controls to ensure continuing appropriateness of the valuation methodology over time and quantify the financial impact of any control breakdown. In addition, it may look at the market information being obtained and benchmark it against industry practices so as to ensure valuation accuracy.

Fair value

In the current environment, determining 'fair value' and what constitutes fair value is becoming increasingly complicated and there are a number of additional factors to consider:

- Is the input used representative of a price that is observable in an active market?
- Is trading activity thin and the last price stale or not representative of the fair value on the date of valuation?
- Is a discount warranted where market participants would not be willing to transact at the quoted price?
- Is the price accessible to the entity in their principal market?
- Does the last trade result in an anomalous price relative to other trades on the date of valuation?

Internal audit can assess the existing valuation process to identify areas where additional procedures should be implemented to ensure the robustness of the process is consistent with market expectations in determining fair value. This function can also analyse the valuation inputs used and assess whether they are representative of fair value on the date of valuation by considering whether all necessary fair value considerations have been incorporated into the valuation process.

Broker quotes and pricing services

Currently, there is increased pressure on the entity performing the procedures to understand the quotes received from brokers, the pricing services and how the valuations have been determined. In this context, asset management entities may consider the following matters:

- Is the broker internationally recognised?
- Are multiple quotes available, and comparable within an acceptable variance threshold?
- Is the quoted price reflective of a market that the entity can access and transact in?
- Does the broker trade or make a market in the quoted security?
- Is the quote based on recent trades or on a valuation model?
- What are the significant assumptions used in the model?
- Are inputs based on available/observable market data?
- Was the model subject to price validation procedures by the broker?
- Are inputs the same as used for the entity's books and records?



To respond to the previous concerns, the internal audit function may:

- Assess the reliability of the price obtained and whether it is reflective of the fair value of the security
- Understand the inputs and assumptions used by the broker
- Assess the reasonableness of inputs and assumptions used and the appropriateness to the entity
- Compare consistency of inputs and assumptions used with those included in the entity's books and records

Compliance and risk monitoring

Investment risk and strategy have long been the main concerns for investors considering a proposed investment; however, operational risk is coming more into focus with investor confidence further shaken by the exposure of recent investment schemes. Investors are now making decisions not only based on the investment strategy of a fund, but also based on the results of due diligence examinations of the investment manager both at the initial investment decision stage and on an ongoing monitoring basis.

Areas of focus for potential investors include:

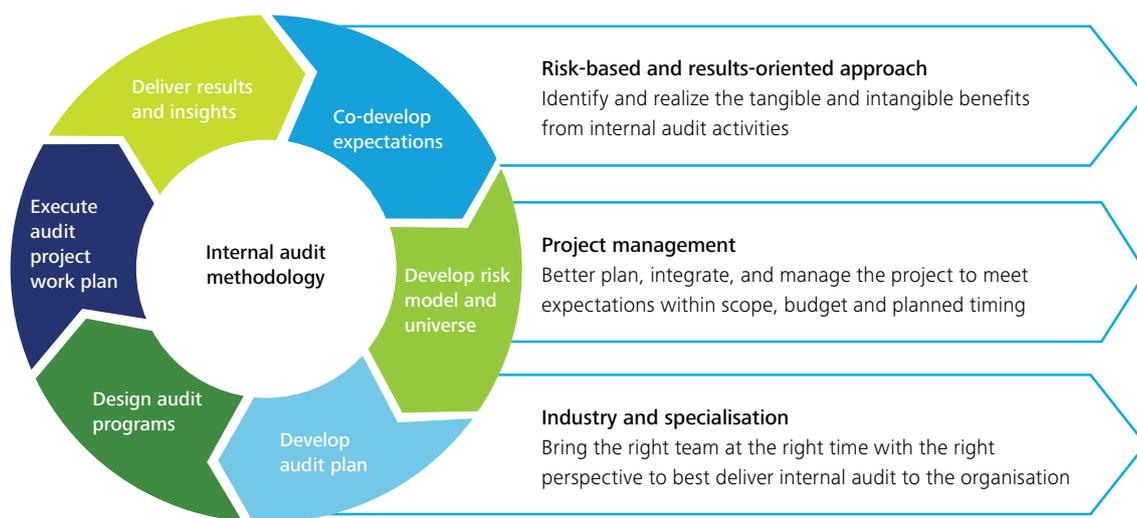
- A robust risk management policy and procedure is documented and is in place
- Segregation of duties exists between front and back office
- Trades are authorised and are made in accordance with the terms of the offering memorandum

- A written allocation policy exists where the investment manager trades for more than one account
- A personal securities trading policy is in place and is monitored
- A parallel set of books and records is maintained and reconciled to third-party administrators
- Verification of the existence of investments and reconciliation of positions between the back office and the prime broker is performed on an ongoing basis

As a result, the internal audit function may prepare asset managers for due diligence requests from potential investors by providing ongoing monitoring and evaluating whether risk management procedures are being appropriately followed, performing external verification of the existence of investments on a periodic/ongoing basis or calculating portfolio exposure including scenarios, stress tests and other risk measures.

"The UCITS IV Implementing Directive of 1 July 2010 introduced significant changes for UCITS Management Companies with regard to organisational and internal control requirements. To ensure that a UCITS Management Company has an adequate control mechanism, the Implementing Directive requires a permanent and independent internal audit function, applying a proportionality principle"

The new internal audit paradigm



Asset management industry governance and risk management trends

- Increased market and investor scrutiny of portfolio performance is resulting in additional monitoring of compliance with valuation and pricing policies and procedures
- Changes in regulatory requirements are requiring additional focus on internal controls and governance
- Increased focus on corporate governance of risk by investors, regulators, boards, audit committees and executive management
- Globalisation/outsourcing/off-shoring changing the roles and responsibilities of internal audit
- Annual risk assessment and audit planning increasing in importance
- Technological advances affecting the scope of internal audit
- Controlling effectiveness of risk management processes using risk-focused model
- Valuation model review and pricing assessment
- Benchmarking trading desk efficiency
- Service provider management and evaluation
- Portfolio risk management consultations and measurement

To the point:

- The current market and regulatory conditions are placing significant demands on asset management firms forcing them to assess a broader risk spectrum across the organisation
- Internal audit can play an important role in looking broadly at risk and helping asset managers to build a more risk-intelligent organisation
- Internal audit is recognised as a fundamental component of a healthy corporate governance structure by improving overall performance and operating efficiency
- The internal audit function may prepare asset managers for due diligence requests from potential investors by evaluating compliance and operational risk management procedures
- With the current market conditions, internal audit can assess the existing valuation process to be compliant with best practice and regulatory guidance

Performance monitoring in asset management

The importance of a customised monitoring system

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Evidence of a strengthening of monitoring practices

The current unsettled economic climate has led to a change in the management controller's role. Previously focused on production, control and analysis, he has become more of a 'business partner', who is required to implement advanced monitoring indicators and assist business unit managers in their decision-making process. To fulfil this new role, the management controller has had to industrialise his processes (reporting production, budget preparation, cost allocation, etc.) and make full use of information systems (through enhanced data quality, decision-making tools and product reporting platform implementation projects).

In a difficult economic climate, with fund inflows plummeting and the financial markets in decline, the asset management industry is undergoing rapid change. Asset managers have had to rethink their strategies, positioning and organisation, and tend to fall into one of two camps: the advocates of economies of scale, or the specialists honing their expertise. In both cases, however, there is a single watchword - flexibility.

To assist in business reorganisations and keep a close eye on results, asset managers transition their monitoring systems to focus on profitability rather than revenue.

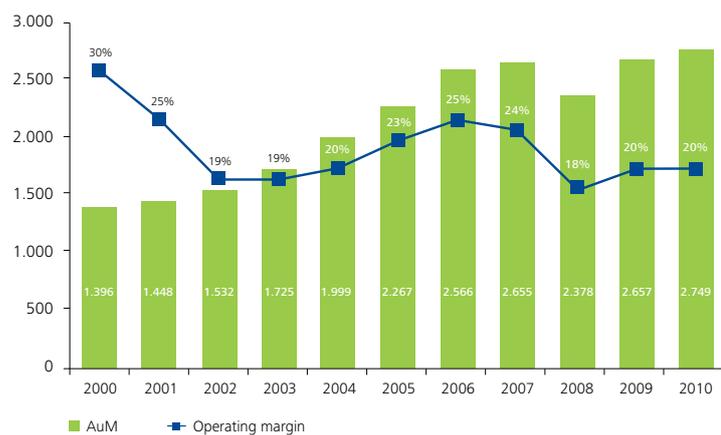
The current unsettled economic climate has led to a change in the management controller's role



The rapid changes we are witnessing can be summarised as follows:

- Research is being conducted into advanced profitability indicator implementation and various approaches to analysis (segment, product, etc.)
- Management control tools have been significantly upgraded recently (reporting platforms industrialisation, dedicated budget preparation tools, etc.)
- Cost allocation methods and tools have been introduced, prompted by the need to break down profitability data (e.g. by channel, segment, etc.) and allocate the appropriate share of indirect costs to each consumer business
- The management controller is becoming more of a 'business partner', as well as an invaluable contact for business unit managers and support functions in discussions with management

Corporate profitability 2000-2010



Creating advanced indicators

The indicators commonly used today are often static and based on past performance. Some asset managers are giving close consideration to creating global KPIs to incorporate all performance data, at every level (financial, commercial, operational), along with 'projected' KPIs (business at risk, projected net banking income, etc.).

The turmoil encountered by asset managers makes the sensitivity of revenue to market factors, especially market volatility, more acute.

Faced with intense and sporadic movements, management firms must now accommodate a new unknown quantity: fund outflows.

This environment has highlighted the need to:

- Create scoreboards to gain insight into client behaviours
- Use indicators that afford a cross-functional view of (commercial, financial, etc.) performance
- Incorporate projected indicators (1 month, 3 months, 6 months, etc. ahead) to perceive the impact on revenue volatility

Areas	KPIs identified in asset management
Portfolio performance	Portfolio/composite gross and net performance
	Performance analysis/risk per portfolio (information ratio)
Assets under management	Funds under management outstanding
	Percentage of fund outflows (%)
Commercial activity	Net new revenue/net new money
	'New to bank' clients net new money/net new money
	Percentage of winning bids (%)
	Number of calls made to prospective clients/target number of calls to prospective clients
Profit or loss	Business at risk (revenue)
	Cost/income ratio (%)
	GDP per FTE, PBT per FTE
IT	IT costs/GDP (%)
	RUN/build breakdown
	IT costs/FTE
	Number of incidents/per annum/FTE
Operations	Average transaction processing time
	Number of claims/number of transactions processed (%)
HR	Turnover rate (%)
	Employees satisfaction rate (%)
	Percentage of vacant positions (%)
	Percentage of exceptional situations (%)

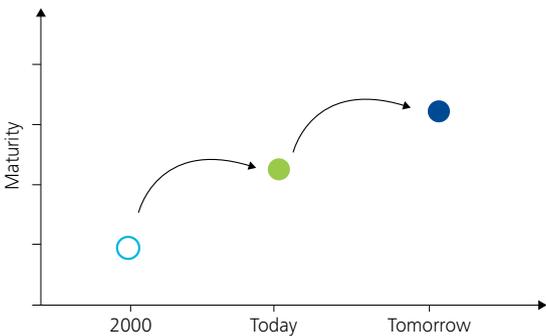
Control over

Management controllers now devote substantial resources to obtaining this depth of analysis of the responses and sensitivity of their liabilities. Most of all, bias should be brought under control. The main steps taken to address this involve:

- Reducing cannibalisation between funds
- Identifying and generating seed money
- Distinguishing new client fund inflows ('New to Bank' clients)
- Indicators are commonly used to monitor objectives by individual (financial, commercial, operational) area. At numerous asset managers', these indicators are unrelated and do not afford a cross-functional view of performance. A few market players have set up 'advanced' KPIs that give them an overview of performance and promptly put these various drivers into action. The purpose of these 'advanced' KPIs is to measure:
 - Gross and net portfolio performance against composites, by incorporating the risk component
 - Fund inflows against fund performance
 - The margin gap between 'New to Bank' and existing clients
 - The ultimate profitability of products (revenue-expenses-provisions/assets under management)

Other indicators are preferred instead of overly static, traditional markers, i.e.:

- Revenue indicators (projected NBI, etc.)
- Risk indicators (business at risk)



- Complex indicator-based monitoring (net new money, business at risk gross operating income by manager, etc.)
- Margin-based monitoring (gross operating income, operating accounts by business unit, etc.)
- Revenue monitoring (GDP, funds outstanding, etc.)

Changes in the management control IT system

Management control tools have been significantly upgraded to help systematise financial reporting and budget preparation.

The need to devote an increasing amount of time to high value-added work led to the creation of tools dedicated to management control.

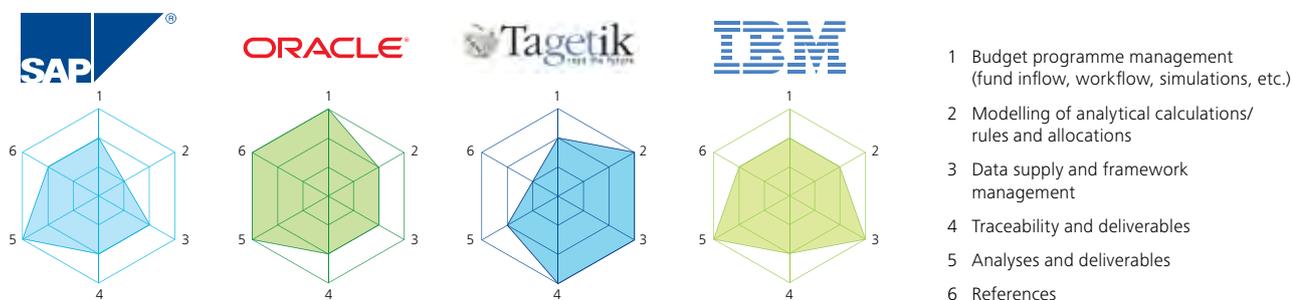
These tools enable production work (data collection/control, electronic delivery/distribution of reporting packages) to be systematised.

Large management firms differentiate themselves through their use of these types of tools over the past few years, and have focused their systematisation efforts on tools that now have short production

times, provided that projects incorporate upstream streamlining work (data, frameworks, etc.).

The quality of data received and the reliability of the processes feeding into the management control systems are key factors. Significant efforts have been made in both areas, with projects aimed at upgrading the quality of upstream data (liability base, performance data, etc.) and strengthening the automatic link between front systems and management control tools (data retrieval from performance and client relationship management databases, etc.).

Upgrading the quality of product reporting also includes setting up shared frameworks and a data-specific governance policy.



Strengths

- Integrated into Excel both in terms of input/data handing, and solution administration (framework update, launching of data supplies)
- Consolidation functionalities included in the standard version
- Solution most widely rolled out within the corporate finance departments of the banking/ insurance industry
- User-friendly data handling and ad hoc analysis interface in Excel
- Pre-packaged work flow, and calculation and management rule modelling functionalities
- Unified solution, incorporating the major functionalities required by financial and operational monitoring in its standard version
- Configuration and administration in the hands of business users (with the exception of the complex management calculations and rules)
- Simple technical installation
- A technology that enables dynamic data updates (in real time) when simulations are performed and configuration and frameworks are changed
- Offering targeted at medium-sized organisations (<100 users) incorporating the B1 module (interactive reporting, scoreboard, etc.) functionalities

Limitations

- Management and calculation rules are configured in a proprietary language, not business-user oriented
- Requires a 100% Microsoft technical environment
- The IT teams have to configure the data model (Cube) and set up the data supplies
- Depending on the technical architectures, installing the solution may be a complex process
- Limited dynamic data handling and ad hoc analysis capacity
- Number of references and specialists still limited in France
- Limited pre-packaged functionalities (including at workflow level)
- Users' full ownership of the system requires advanced training

Tools dedicated to budget process management seem to have become indispensable to major asset managers as the environment requires increasingly short budget cycles.

Although Microsoft Excel is still used by a majority of management controllers for budget process purposes, the major asset managers have implemented dedicated software packages (e.g. Oracle Hypérior Planning), which provide:

- Shared documentation for distributing budget framework assumptions, changing data and formalising information exchange
- Time savings for the consolidating entity, especially in terms of control monitoring and performance
- Responsiveness (shorter production time) and intra-period search capabilities

These issues are also shared by smaller organisations, but the used resources show a larger contribution from new tools.

Cost allocation method and tools

The need to fine-tune the profitability monitoring process has resulted in the implementation of cost allocation tools. We have therefore looked at how business leaders considered and implemented methods and software packages, although most medium-sized market players use office automation tools (Excel, Access, etc.).

We observed that all major market players sought to determine their direct cost 'profitability' (NBI over direct costs) in their organisational, product and client segments:

- *Organisational segment*: market players aim to determine the individual profitability of each business unit, department, management team and manager
- *Product segment*: they need to determine profitability by individual product to identify which are most/least profitable
- *Client segment*: they need to allocate data by client segment and meet distribution channel requirements

Contract-level monitoring (the point at which the organisational/product/client segments intersect) remains an exception. It seems that this level of granularity can be calculated by only a small number of institutions.

Many market players still need to improve the balance of time spent on value-added and traditional production work. This implies that continued systematisation of production tools should be the guiding principle of change.



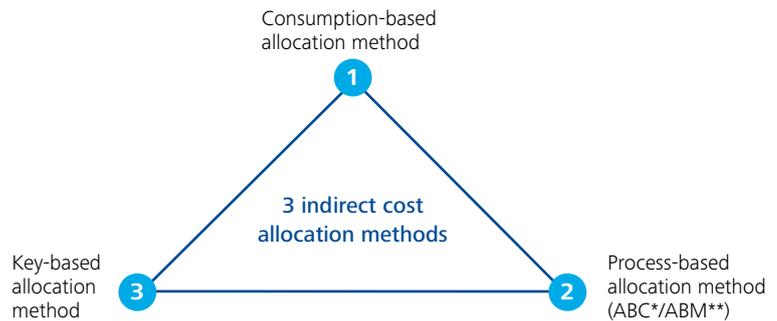
We also observed that asset managers somewhat traditionally used the following three indirect cost (operations, IT, HR, etc.) allocation methods:

- Key-based allocation method: indirect costs are allocated by key (AuM, NBI, FTE, etc.) to management teams
- Process-based allocation method (Activity-Based Costing /Activity-Based Management-type method): indirect costs are allocated by process via internal billings based on consumption. These billings traditionally rely on annual timesheets
- Service consumption-based method: billings are based on an annual service price list. Expenses are billed by entity based on their consumption (unit price* volumes consumed). This method is particularly relevant to market players setting up dedicated expertise backed up by distribution platforms and pooled support functions

These methods may be complementary and implemented in different areas (e.g. process-based allocation in operations, service consumption allocation method in IT).

The increasing use of pooled resources has resulted in a review of the methods used in management control to allocate indirect costs and bill them as accurately as possible to user businesses.

Illustration of the cost allocation methods identified at French asset managers:



- 1 Consumption-based allocation method**
 - + • Billing of actual service consumption
 - A see-through method which helps to identify cost drivers
 - • Need to plan volumes used as closely as possible
- 2 Process-based allocation method (ABC*/ABM**)**
 - + • Billing of actual service consumption
 - • Heavy maintenance workload (list of processes to be kept updated)
 - Difficulty in communicating in a straight forward manner on full costs per service
- 3 Key-based allocation method**
 - + • Simple to implement
 - • Billing based on parameters without direct control
 - Challenge to the keys used by the businesses

Human capital

As is the case throughout the financial services industry, the HR function's human capital management process has evolved in line with the change in the business partner's role, and its importance *vis-à-vis* senior management has increased. Today's management controllers have greater opportunities to advance in their organisations.

We observed that corporate finance departments increasingly represent senior management's primary contact for performance indicator feedback. Financial monitoring, including follow-up on income statement and balance sheet items, is still the core function of finance teams. However, corporate finance departments often play a leading role in financial monitoring, and an information provider role on behalf of senior management. This role consists of escalating and aligning information in various areas (fund performance, commercial, IT and operations monitoring, etc.) and offering an overview of performance.

Financial monitoring encompasses an increasing number of issues. In addition to explaining figures, financial reporting must incorporate all aspects of performance (financial, commercial, operational) and highlight the drivers (commercial performance, product profitability) via advanced indicators.

To fulfil these new duties, various profiles (economists, project managers, etc.) have recently been recruited to fill management controller positions. These individuals can contribute a complementary range of leading edge technical competencies.

For almost all market players, the management control function is now viewed positively and is an asset. The exchange of information with other departments helps management controllers gain a wide understanding of operations and acts as a springboard towards line management positions. However, holding a management control position has by no means become essential to attaining a senior management position.

To the point:

The current unsettled economic climate has led to a change in the management controller's role. In their new role, management controllers had to systematise their processes (reporting production, budget preparation, cost allocation, etc.) and their information system (data quality enhancement, decision-making tool and reporting production platform implementation projects). The rapid changes we are witnessing are the following:

- Research is being conducted on advanced profitability indicator implementation and on various approaches to analysis (segment, product, etc.)
- Management control tools have been significantly upgraded recently (reporting platform systematisation, dedicated budget preparation tool, etc.)
- Cost allocation methods and tools have been set up, prompted by the dual need to identify profitability in the approaches to analysis (per channel, segment, etc.) and allocate to each consumer business its share of indirect costs
- A change in the management controller's role, which has become that of a business partner, and a legitimate contact for business unit managers and support functions in the management dialogue

OTC derivatives

Meeting the new regulatory challenges

Joseph Saliba
Deputy Chief Executive Officer
Caceis

At the 2009 Pittsburgh summit, the G20 member countries agreed to take bold measures to enhance transparency, reduce counterparty risk and monitor the operational risks associated with OTC derivatives in a coherent manner and on a global level.

The stakes are high because the notional volume of OTC derivatives traded stood at US\$601 trillion at year-end 2010 according to the Bank for International Settlements.

The OTC derivatives market is facing three major reforms that come into effect in early 2013. In Europe, Basel III, which will be applied in the first quarter of 2013, focuses on changing capital requirements on counterparty risk, encouraging increased use of central counterparties (CCPs) for OTC transactions and transaction collateralisation. Furthermore, it lays down new requirements regarding contributions to the CCP guarantee funds. The European Market Infrastructure

Regulation (EMIR), which is also scheduled to come into force in the first quarter of 2013, sets out new requirements for standard OTC Derivatives (e.g. Interest Rate Swaps (IRS) and Credit Default Swaps (CDS) clearing by CCPs. It also lays down collateralisation constraints for uncleared derivatives in CCPs, including foreign exchange (forex) forwards and swaps, as well as listing new requirements for centralised reporting for all derivatives transactions. Finally, in the United States, Dodd-Frank sets out similar modifications to those of EMIR but for the U.S. derivatives market, including centralised clearing, margin calls with segregation and trade repositories reporting.



The European Securities and Markets Authority (ESMA) shall be defining the technical standards during 2012, though practical rules are yet to be finalised. Regulatory authorities on both sides of the Atlantic are cooperating to develop harmonised standards. Even so, differences are emerging and numerous points have yet to be clarified.

Will all OTC products be centrally cleared?

The existence of a CCP for an individual OTC product is a prerequisite for centralised clearing. Operational CCPs exist only for standardised OTC products, such as CDS and IRS, which make up some eighty percent of the total volume of the OTC derivatives market. I think that the lack of a CCP for the remaining twenty percent will mean that cleared and uncleared products will continue to coexist for some time yet. Even within the CDS category, although index-linked CDS are in scope, there remains uncertainty as to the cleared status of single-name CDS, and discussions are ongoing between ESMA and the CCPs.

EMIR also includes some clearing exemptions for instruments such as forex forwards and swaps, but these transactions will not escape the collateralisation and trade repository reporting obligations.

The OTC derivatives market is facing three major reforms that come into effect in early 2013

Also, non-standard OTC derivatives such as performance swaps, asset swaps, cross currency swaps, inflation swaps, swaptions, options on currency and structured products will remain bilateral, but reporting obligations and collateralisation will be mandatory. There are also a number of other exemptions concerning intra-group operations, non-financial counterparties below a certain clearing threshold, pension funds and ongoing bilateral operations negotiated before 1 January 2013.



What will this mean for institutional investors and asset managers?

The changes will require institutional investors and asset managers to adapt to a new contractual set-up with documentation to be established and signed between each fund and the executing broker, the clearing member and the CCP. This documentation is essentially standard agreements, which will, it seems, offer little in the way of flexibility.

These changes will also place collateral issues under the spotlight for institutional investors and asset managers, and according to a March 2012 Reuters News report: *"The U.S. national bank regulator has said that the changes introduced by Dodd-Frank, Basel III and EMIR could increase the value of collateral by US\$2 trillion, an increase of 50% on current levels."* Indeed, the impact of Basel III on collateral values must be seriously considered, as banks are the main counterparties for OTC transactions. However, questions remain on where the financing, and especially cash, can be sourced, and on the use of securities as collateral.

For cleared derivatives, as for listed derivatives, collateral will be calculated by the CCPs, but for non-centrally-clearable derivatives players have a number of options for calculating the initial margin. ESMA nevertheless recommends that a VaR model be used for all initial margin calculations. Use of a third-party clearing member is key to a smooth target operational process between the institutional investors and asset managers, the CCP and the counterparties. An important consideration in this case is whether the clearing member should use an omnibus account with the CCP, where collateral needs are optimised with the CCP but through the netting process, a risk of unfair treatment for security holders is generated if a fund fails. Segregated accounts, on the other hand, do not carry a netting risk between funds but collateral is not optimised with the CCP.

I believe that, generally, depositaries will elect for segregated accounts for risk reasons, but very thin segregation levels serve to reduce clearing members' profitability and do not permit as much collateral re-use. I am of the opinion that depositaries also offer greater reliability and neutrality for collateral management and optimisation as they have been required to segregate assets and collateral for many years. Asset servicing companies like CACEIS can provide a comprehensive and centralised service for OTC derivatives processing which allows companies to fully outsource their back-office administrative processes with services including full market connectivity, transaction processing and reporting and collateral management.

An asset servicing company can centralise the entire OTC derivatives management process whether they are bilaterally cleared or even cleared by a number of different clearing members. This provides a central monitoring access point and increases the transparency of operational processes for the asset manager.

To what extent will the middle office of asset management companies be affected?

There will be a significant volume impact on the middle office as a large proportion of OTC derivatives will be cleared via a CCP, but not all instruments will be covered. The asset manager must consider whether keeping an in-house derivatives clearing middle office for the reduced volume of non-standard (and usually more complex), non-centrally clearable instruments is economically viable under these conditions. Another consideration is the need to collateralise all the required OTC derivatives, including forward forex. I believe that many managers will question whether their current infrastructure will allow them to meet these enhanced collateralisation requirements, especially in terms of the need for cash and high quality securities.

I believe that the investment management community will increasingly look towards leading asset servicing providers for a comprehensive collateral management offer and assistance in developing their OTC activities with multiple counterparties. The providers should offer a dedicated system with interfaces between a collateral management platform and the securities and cash platforms to facilitate valuations, margin-call calculations, controls and settlement.

I would argue that we will see asset managers also turning to their providers for assistance in both converting securities into cash, and exchanging securities that are ineligible for use as collateral with eligible securities. This type of operation will be key in meeting the challenges of mandatory collateralisation of all OTC derivatives, which will result in greater need for liquidity and high quality securities. Through the provider's trading room and specifically the securities lending and repo desks, this process can be fully



automated and yet have no impact on the availability of securities for sale. The provider should be able to monitor all types of collateral and optimise the management of that collateral through a schedule programme.

In the years to come, OTC derivatives will remain a key part of the investment manager's portfolio management toolkit, yet with the regulatory environment increasing the administrative burden on clearing and collateral management, more and more managers are reassessing the economic viability keeping these parts of their business in-house at a time when there is ever greater competition on fund costs. By turning to their asset servicing partner for help in improving the efficiency of their OTC derivative operations, they are mitigating the risks involved and achieving better focus on their core business of asset management.

To the point:

- Three major regulatory developments will impact OTC derivatives transactions
- Clearing and collateralisation requirements for each product type must be met
- Lower bilateral clearing volumes and higher collateral amounts favour outsourcing

Senior secured credit

When two become one

This document has been prepared by the loan and high yield professionals of ECM, a Wells Fargo company.

Why investors could benefit from investing in both senior secured loans and senior secured bonds.



Introduction

In the years since the collapse of Lehman Brothers, several factors have combined to create a new opportunity for investors in sub-investment grade credit. This opportunity arises from the combination of loans and bonds at a single level of seniority in the capital structure—senior secured credit. Investors have the potential to make high single-digit returns over the medium term if they take appropriate advantage of both the similarities and differences of the loan and bond asset classes.

This paper will look at why the opportunity has arisen now, what the loan and bond components of the asset class bring to the table, and what is required of an asset manager to make a success of this opportunity.

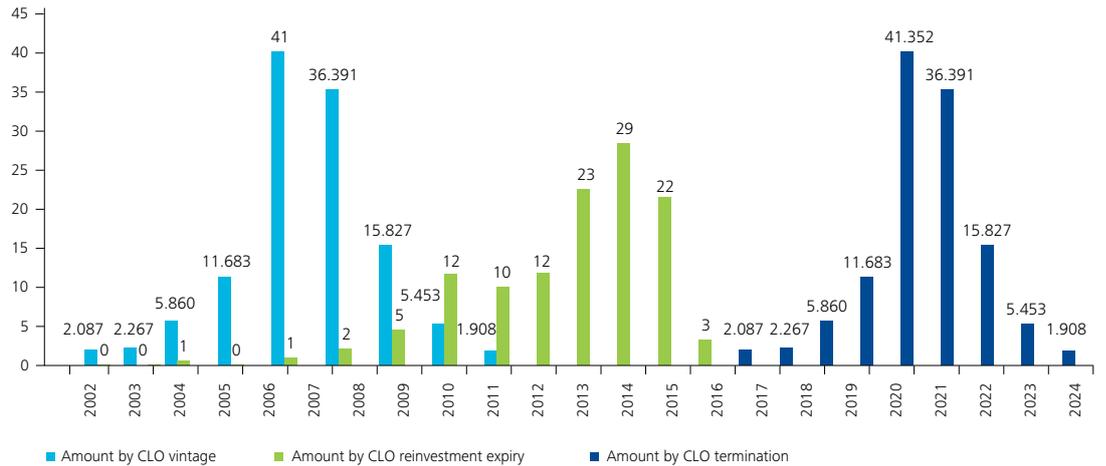
The opportunity—why now?

The landscape of sub-investment grade credit has been permanently changed by the crisis of 2007-2008, and has opened the door to new types of investment that combine sub-investment grade asset classes which used to be distinct.

There are several reasons for this:

- Prior to 2007 the most important investment vehicle in the loan market was the Collateralised Loan Obligation (CLO). By the middle of 2007 these vehicles made up an estimated 36% of the new issue loan market. Since then, the lack of structured finance issuance generally has combined with new regulations from Brussels to diminish new European CLO issuance very significantly. The few vehicles that have managed to print in Europe have been balance sheet management exercises by banks rather than open market transactions. At the same time, the CLOs that were issued prior to the shutdown of the market will begin to wind down in accordance with their fixed final maturities. CLO managers will be required to stop re-investing in new loans some time before vehicles approach final maturity. The chart below shows that while the final maturity dates of most CLOs are still some way off, the reinvestment periods are beginning to expire now. This creates a liquidity gap in sub-investment grade credit that will need to be filled by other investors. We believe that these investors will be able to step in and lend money at rates and terms that have not been possible until now

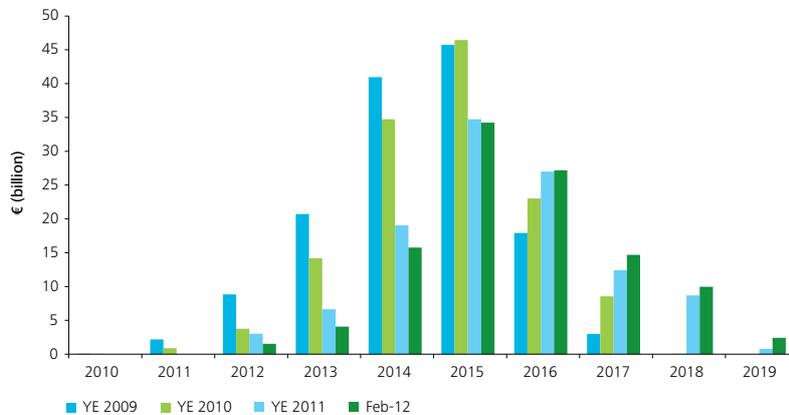
European CLO reinvestment window and maturities (\$ billion)



Source: J. P. Morgan, Intex. The calendar is based on the current outstanding of Euro CLOs (about US\$120bn), not discounting for future prepayments or defaults

- The vigorous issuance of CLOs prior to 2007 was matched by a boom in senior loan issuance, which averaged €91 billion per year in 2003-2006 and peaked at €165 billion in the first half of 2007. Since then, loan issuance has averaged €39 billion each year. Loan maturities are typically between seven and nine years, so the loans that remain outstanding are now coming to a point where they need refinancing. This is often referred to by commentators as the 'maturity wall'. The maturity wall can be addressed in several ways, and many loans have already been 'removed from the wall':

Historical maturity schedule by par outstanding



Source: Standard & Poor's, 'ELLI (February 2012)'

The usual ways are through extension amendments (A&E), refinancings (loans or bonds) or M&A activity. The first two of these present an opportunity to invest in well-known companies at spreads that are usually twice as high as the original loan spreads.

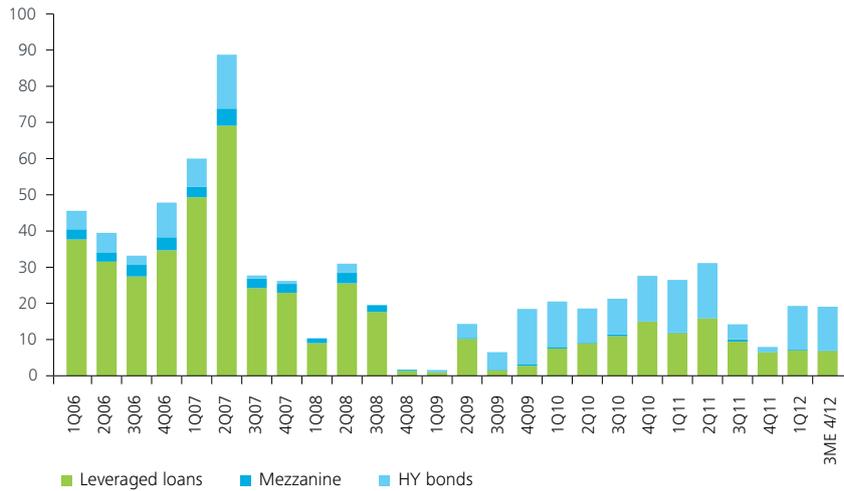
- M&A activity has begun to pick up in the years since 2008, and the private equity community is likely to be at the forefront of deal-making. Prequin estimates that European private equity firms are sitting on €180 billion of capital available to spend on new portfolio companies. At the same time they need to be able to demonstrate to existing and new investors that they are able to sell the companies they already own at a profit. In our view, these two dynamics will mean private equity-owned companies continuing to change hands, which will in turn require funding from the senior secured loan and bond markets. As well as providing new issues for the loan and bond pipeline, we believe this M&A activity will drive loan market returns through pre-payments of loans trading below par. With an average bid price of 85, the Standard & Poor's ELLI index shows that there is plenty of upside available from a pick-up in M&A activity
- European banks are undercapitalised and the new post-crisis regulations (such as Basel 3) that are being implemented over a number of years will mean they have to improve their capital ratios. While we still expect them to be active in the sub-investment grade market, the new capital requirements will cause them to hold fewer assets. This presents two opportunities for the shrewd investor: the first consists of buying loan assets from bank balance sheets at a suitable discount, while the second comes from greater access to the resurgent good quality primary market



- Ratings trends of recent years have meant that more corporates are entering the sub-investment grade credit arena through downgrades. As we see it, this should mean that for the foreseeable future an increasing section of the loan and high yield bond markets will finance levered corporates not associated with private equity. Many of these names are better known to the bond market than they have been to the loan market so far. Though these 'fallen angels' have not previously been required to offer security, we believe it is likely to be an aspect of any new issuance they require in the sub-investment grade universe

Recent issuance in the loan and bond markets has reinforced the trends that we have seen developing since the markets reopened in 2009 and 2010. We believe that there is now an opportunity for investors to take advantage of a need for financing that can be provided through two different instruments. The chart below shows that while the loan market was clearly dominant in the years leading up to 2007, in the years since the collapse of Lehman Brothers the high yield bond market has become as important as loans as an asset class.

Sub-investment grade credit by asset class



Source: Standard & Poor's, 'European Monthly Review (1Q12)'

The next sections of this paper will look at each asset class in more detail. A table illustrating the characteristics of the two asset classes is shown below.

Loan and bond attribute comparison

Characteristic	Senior secured loans	Senior secured bonds
European market size	€440 billion	€69 billion
North American market size	US\$1,236 billion	US\$271 billion
Issuing company size	Small and large	Mid to large
Investor types	Banks/institutional	Industrial/retail
New issue price/spreads	OID 97-99.5/Euribor +4-5%	Priced at a new issue premium usually 6-11%
Coupon	Floating	Fixed
Typical maturity	5-8 years	7-10 years
Callability	Anytime at par	3-5 year non call
Effective duration	Short	Intermediate
Volatility	Low	Medium
Security	Secured on the assets & shares	Secured on the assets & shares
Ratings	BB+ to B-	BB+ to B-
Voting rates	On every transaction	Starting to become market standard
Covenants	Maintenance*	Incurrence, but getting better
Settlement	T+7-10	T+3
Transferability	Majority consult with issuer	Freely transferrable
Recovery rates	80%**	64%**

Source: ECM

* typically 4 main types Net Debt/leverage, Interest cover, Cashflow/Debt service, Capex

** Moody's global 'Corporate Default and Recovery rates, 1920-2011'

Resurgence of senior secured bonds

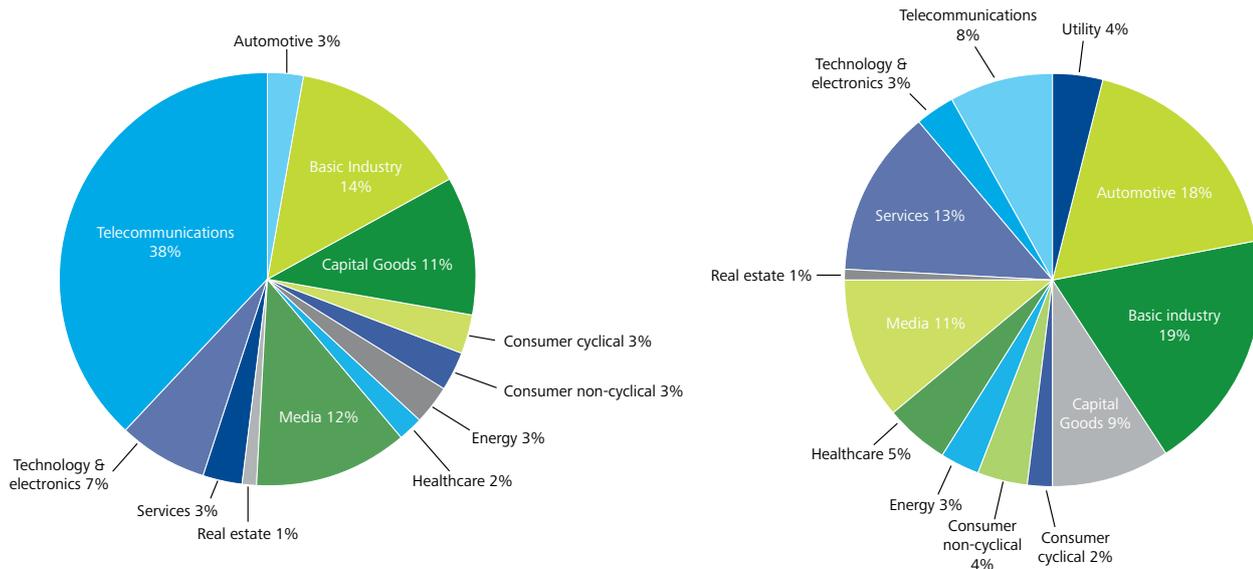
Before 2007, the high yield market was not often used by European sub-investment grade issuers. The availability of plentiful mezzanine financing, the complexities of issuing public securities and the non-call provisions of bonds meant that issuers turned to mezzanine loans for subordinated financing. The senior secured bond market barely existed at all in Europe as senior secured loans dominated.

All this changed after Lehman as the loan market took a longer time to recover than the bond market. Standard & Poor's estimates that European senior secured loan issuance in 2009, 2010 and 2011 stood at €15 billion, €42 billion and €44 billion respectively, whereas in the

same years, high yield bond issuance was €32 billion, €52 billion and €46 billion respectively. A virtuous circle of fund inflows leading to further issuance has been created. The surge in issuance over these three years has brought more diversity and depth to the bond market. The pie charts below show the increase in sector diversity and balance in the high yield bond market over the last 11 years:

Recent issuance in the loan and bond markets has reinforced the trends that we have seen developing since the markets reopened in 2009 and 2010

The increase in high yield sector diversity



Central to the development of the high yield market has been the emergence of the senior secured bond. Whereas historically most high yield bond issuance had been subordinated to loans in the capital structure, the last two years has seen an increase in senior secured bonds to the extent that in the first quarter of 2012 it is estimated that they made up 51% of the new issue high yield market as can be seen in this chart:

Composition of European high yield bond issuance



Source: Barclays Capital (March 2012)

These bonds are structurally very similar to loans in that they:

- Benefit from the same security package as loans. In many cases the protection afforded is identical to that of a senior secured loan. That being said, investors should be wary of bonds that are not as 'senior secured' as they might appear, and should pick a manager able to make the important distinctions required
- Carry similar voting rights to loans. Previously bond holders did not have the same enforcement rights as loan lenders, even if they shared the same security package. In recent transactions, the principle of 'one euro one vote' has become more widespread
- Have covenant packages, which, while not as strong as for loans, have become stronger. We have seen structures where high yield bond proceeds are passed by way of covenanted loans from an SPV bond issuer to the borrower's operating subsidiaries

We believe these changes should mean that recovery rates for senior secured bonds will be higher than those previously seen in high yield bonds. Recovery rates for high yield have historically been considered to be in the region of 40%, whereas the senior secured bond asset class has typically seen recoveries of 60-65%. Recent research from Standard & Poor's suggests that defaulting loan recoveries were 76% on average in the 2003-2010 period. One reason for the differences in recoveries is the callability of loans, which means that prepayments prior to default are applied to the loans rather than the bonds. Recent developments around covenants and voting rights as mentioned above may mean that senior secured bond recoveries get even closer to those of loans.



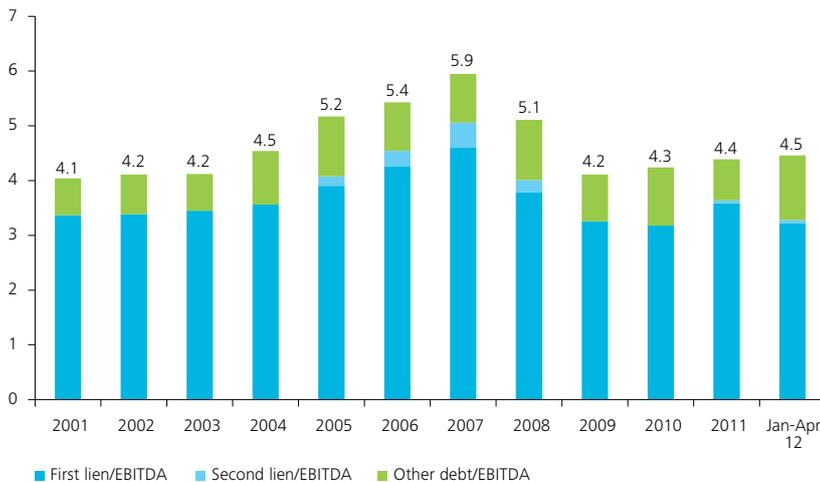
Senior secured loans—reviving steadily

Loan market issuance over the post-crisis period has remained subdued relative to the explosive growth in high yield and senior secured bonds. This has been largely due to persistent questions about the depth of liquidity in the loan market. The continuing dearth of new CLO issues and the deleveraging of banks across the eurozone have been the most cited factors. International bank lending in Europe has certainly decreased post-2007, but banks remain willing to lend in their own jurisdictions as they come under political pressure to support local companies. For the 12 months ending March 2012, European banks made up 40% of the European primary loan market and non-European banks a further 10%. At the same time, institutional investors have found other ways to invest in the loan market away from buying CLO liabilities.

Some managers have turned to publicly-listed vehicles with tradable share classes, but the majority of new money has come into the asset class through open-ended marked-to-market vehicles (e.g. Luxembourg SIFs, Irish QIFs or medium-term note programmes). There has also been a lot of money raised by distressed funds that are looking to capitalise on the deleveraging of banks and the inability of some companies to refinance their debts.

Recent European loan market issuance has been of a much improved quality compared to that of the pre-2007 loan market. Total leverage multiples have come down from an average of over 6x EBITDA in 2007 to just over 4x in the first few months of 2012 (much closer to longer-term average multiples). This chart shows the progression of leverage multiples over the last decade:

Borrower leverage multiples have decreased since 2007



Annual Pro Forma Debt/EBITDA Ratios

Source: Standard & Poor's. 'European Monthly Review (April 2012)'



Equity contributions from private equity sponsors have also risen dramatically. In 2007, a sponsor could invest as little as 20% of the capital structure; these days equity cheques tend to be in the 40-50% range. Statistics from Standard & Poor's show that in the first three months of 2012, the average equity contribution was 46.7%, the average total debt to EBITDA was 4.3x and the average senior debt to EBITDA was 3.6x. At the same time as having better credit metrics, loan investors are also getting paid more for the money they lend. In 2007, the typical loan margin would have been in the region of 250 bp over Libor. Today, loan margins are over 500 bp and upfront fees are helping to push new issue yields close to 6%, in a low interest rate environment. Another lender-friendly feature has been the introduction of 'Libor floors'. While loans have always been an effective hedge against rising interest rates, many loans now feature protection against base rates dropping very low. Originally these floors were a feature of the U.S. market where they appear in almost every transaction. The European market has been slower to adopt them as interest rates in the eurozone remained higher for longer, but now most of the larger new European transactions have Libor floors. Typically these floors are set at 1-1.5%.

As well as new issuance refinancing or supporting new buyouts, the European loan market has seen a marked increase in A&Es. These transactions involve the borrower coming to the lenders and asking for a maturity extension in exchange for a margin increase on the existing debt. In addition, these requests often include changes to the documentation that allow the possibility of future bond issuance or IPOs. The advantage to borrowers here is that they don't have to risk approaching the potentially volatile new issue market. Lenders get an improvement in the terms offered for a company with a proven track record. They can also refuse to extend if they would prefer to be repaid at the original maturity date, although most of these transactions have a hurdle rate for acceptances that the borrower is looking to achieve so as not to end up with too small an extended tranche. A&Es are particularly popular with CLOs as they are able to extend without making a 'new' investment after the end of a vehicle's reinvestment period.

While the progress of the European market has been steady, and in the main, conservative, the U.S. market has rebounded more aggressively and is beginning to exhibit signs of being overheated. The relative size of the market and the ability of retail investors to easily access it have meant that liquidity in the U.S. has been much stronger, so prices have rebounded faster and further from their lows than in Europe. The U.S. equivalent of the Standard & Poor's ELLI has a weighted average price of 95—seven points higher than the ELLI. This surge of liquidity has also meant that new issue terms have been quicker to erode in the US than in Europe. As well as creating a more volatile new issue spread market, features like 'covenant lite' became commonplace in the U.S. in the first half of 2012. With better yields and more conservative terms, in our view Europe appears to be better value than the U.S. at the moment.

Of course there will be companies that are unable to refinance or extend their upcoming maturities. These companies will need to go through restructurings to address their capital structure issues. We have seen distressed investors position themselves to take advantage of these situations when they arise. It should be noted, however, that the protection which the senior secured position gives to investors has meant that recovery rates in senior secured loans have tended to be strong throughout the cycle—76% on average between 2003 and 2010, according to recent Standard & Poor’s research.

What differences remain between the two asset classes?

The obvious difference between the two asset classes is that a bond is legally a 'security' whereas a loan is not. Loan terms are private by default but can be partly released in instances where there is an intention to add a bond to the capital structure. The public versus private debate is one that is ongoing in the European sub-investment grade credit market. Loan investors that also invest in bonds need robust policies and procedures in place to manage the conflicts that can arise from investing in both asset classes.

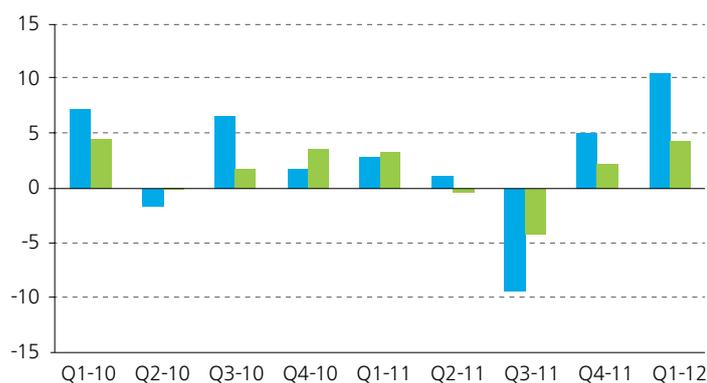
Another key difference between the asset classes is that loans are always floating rate whereas senior secured bonds are, for the most, part fixed rate. This means that loans provide a natural hedge against rising interest rates. As discussed above, they are also increasingly protected from falling rates by the presence of Libor floors in loan structures. For the effective management of interest rate risk in the bond market, we believe a manager should have professionals dedicated to duration management within the investment team.

The private nature of loans has led to a misconception that loans are an illiquid asset class. This is not the experience of our firm, which has been transacting large volumes in the secondary market in all of the eight

years in which we have been managing loans (we have been trading in the high yield bond market for twelve years). The loan market trades regularly and, in our view, is as liquid as high yield. It is true that settlement times for loan trades are longer than for bonds. This arises from the private nature of loans and the requirement for three separate documents to be signed by three separate parties for loan trades. Initiatives are being undertaken to address this issue, but it is important when dealing in either or both of the loan and bond markets that a manager has the appropriate infrastructure. This means dedicated traders for each asset class as well as sufficient personnel and systems to cope with the middle and back office requirements. We believe that active trading in the primary and secondary markets for both asset classes will ensure the best access to transactions and trading ideas.

Performance and volatility have also differed across the loan and bond asset classes. As the chart below shows, in recent times the Merrill Lynch HEAD Euro Non-Financial High Yield Index has tended to outperform the S&P ELLI in rising markets and underperform it in falling markets:

Merrill Lynch HEAD v S&P ELLI total returns



Source: Bank of America Merrill Lynch, Standard & Poor’s European Leveraged Loan Index (ELLI)

This relative lack of volatility has been a feature of the loan market for many years—apart from 2007 and 2008, when the deleveraging of the loan investor base caused unprecedented levels of volatility in the asset class. According to JP Morgan, over the last 15 years in the U.S. market, loans have had a standard deviation of 6.7% (a measure of how far prices depart from the average over a time period), while high yield bonds had a standard deviation of 9.4%. If 2008 and 2009 are excluded, the difference is more extreme. U.S. loans had a standard deviation of only 2.8% compared

to 6.4% for high yield. Low relative volatility in the European loan market is primarily due (as it is in the U.S.) to the senior secured position that loans occupy in the capital structure. In our view it is likely that the return volatility of a senior secured asset class made up of loans and senior secured bonds would sit between the loan and high yield indices in the chart overleaf, but be much closer to the loan index than the high yield index, which contains a majority of subordinated issuance:

Selected asset class returns and volatility

Jan 2009-Mar 2012	Annualised return	Annualised return volatility
CS West. Euro. High Yield Index	26.06%	15.07%
CS West. Euro Leveraged Loan* Index	16.92%	9.17%
Credit Suisse US High Yield Index	22.90%	11.56%
Credit Suisse US Leveraged Loan Index	17.27%	8.53%
FTSE All-Share (GBP)	13.89%	18.35%
DAX Index	11.97%	26.78%
S&P 500	17.15%	21.76%
Ger 10+ Yr Govt	9.10%	12.74%
UK 10+ Yr Govt (GBP)	7.32%	11.71%
U.S. LT Govt	4.70%	13.94%

Source: Credit Suisse (quarterly report)

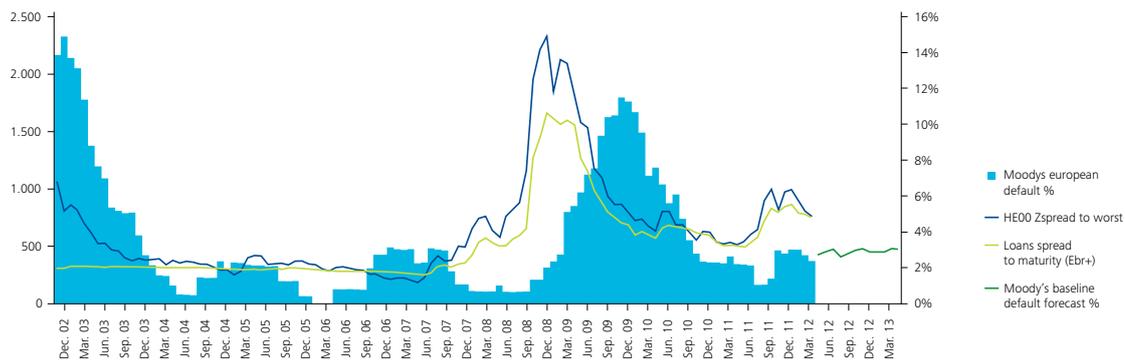
* Credit Suisse term for Senior Secured Loans

Conclusion

In our view, it is clear that a mix of loans and bonds in a senior secured asset class will provide strong returns combined with the best downside protection available. We believe that the liquidity gap that is developing through the decline of the European CLO market and the retrenchment of the European banking sector will mean that lucrative opportunities will become available in sub-investment grade credit. The position of senior secured loans and bonds in capital structures should mean that both asset classes will benefit from strong recoveries going forward.

While speculative default rates may well rise, we believe that the spreads available, combined with these strong recoveries, provide generous compensation for this risk:

High yield and loan spreads versus default rates



Sources: Standard & Poor's ELLI, Bank of America Merrill Lynch High Yield Index (HE00) & Moody's Speculative Grade Monthly Report

Investors wishing to take advantage of this opportunity will find that many of the traditional differences between loan and bond asset classes have become blurred, particularly with regard to lender protection. However, differences remain and we believe investors would be well advised to choose a manager that has extensive experience through multiple cycles, and is best qualified to play the arbitrage opportunities that will arise across asset classes, jurisdictions and currencies.

To the point:

- Refinancing needs, M&A, the deleveraging of Europe's banks and the decline of the CLO market have combined to create a need for senior secured sub-investment grade funding across bond and loan asset classes
- We believe investors will be able to make high single-digit returns over the medium term with excellent downside protection from a senior secured position in the capital structure
- Both asset classes benefit from high recovery rates and low exposure to peripheral Europe
- The senior secured bond market has developed considerably in the last three years. The quantity and diversity of issuers has increased greatly across sectors and regions. New features that put senior secured bonds on a more equal footing with loans are becoming commonplace
- Recent issuance in the European senior secured loan market has been of a much higher quality than was seen in 2007 and before. Leverage levels, sponsor equity contributions and returns are all much more favourable to investors. The maturity wall is being addressed through a combination of refinancings, extensions and M&A. Higher spreads and terms that provide better protection for investors mean that, in our view, the European loan market is currently better value than its US equivalent
- A manager that has experience across both asset classes through multiple cycles should be well placed to generate strong returns for investors with lower volatility from a combination of senior secured loans and bonds. In our view, good credit selection, an integrated loan and bond team, plus an ability to effectively arbitrage both markets through strong secondary market access are key attributes for a manager



EMIR—Dodd-Frank

A challenge for European asset management firms and their custodian banks within a non-stabilised regulatory framework

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New Product Manager
Asset Managers - Asset Owners
Société Générale Securities Services

**EMIR, entered into force on 16 August 2012,
is radically transforming the OTC Derivatives market.**

However, the regulatory framework is far from stabilised and the technical norms that will enable EMIR to be applied effectively are thus still being discussed. ESMA organised a public hearing on the matter on 12 July 2012, where it was suggested that no clearing obligation is likely to be made applicable before the summer of 2013. The initial objective was to have it

applicable from 1 January 2013. Furthermore, talks led by the Basel Committee and IOSCO are currently taking place and will continue through 28 September 2012 where the crucial issue of collateral requirements for non-standard OTC derivatives are being discussed. However, the regulators' caution and concerted action should be applauded.

In terms of volumes, the nominal amount of collateral required should double by 2013, while collateral movements should increase seven-fold.

EMIR and Dodd-Frank: doubled collateral requirements and dramatic increase of movements

	Today Limited and flexible requirements	2013 increased and systematic requirements
Worldwide collateral	USD 3 trio	USD 6 trio
Nature	Mainly mark-to-market (few IA)	Bilateral: MtM + IA / CCP: VM + IM
Reciprocity	Mainly 1-way CSA	Mainly 2-ways
Eligibility/haircuts	Flexible bilateral agreements	CCP/regulators rules
Type of collateral	80% cash, 20% securities	➤ Securities
Frequency	Weekly	Daily
Number of collateral contracts	170,000 CSA	256,000 CSA
Number of daily movements	170,000	124,000

Sources: JP Morgan, Tabb Group, Citi white papers

Major challenges

For asset managers using OTC derivative instruments in their funds, this challenge is now setting up new operational processes, which means choosing clearing brokers, among other things. But they also need to take into account the impact of the new collateral requirements on asset management, and especially the systematic introduction of the 'initial margin' in addition to the already well-known 'variation margin', which is designed to hedge the mark-to-market variation of an OTC derivative instrument. The initial margin is a permanent additional collateral buffer in the form of cash or securities, the value of which is regularly reassessed. This will undoubtedly make life more difficult for asset managers and the optimisation and

transformation of a fund's assets liable to be used as collateral will therefore become crucial. Indeed, if a clearing house calls on a fund as collateral, the fund manager has to decide which collateral is the cheapest to deliver. Faced with a possible temporary lack of eligible collateral, cash or securities, the fund manager must also anticipate the transformation strategies which need to be implemented and which will most probably entail the setting up of lending/borrowing operations.

For custodian banks, the challenge is to build suitable high-performance infrastructures capable of supporting a much higher and more complex daily volume. This requires substantial IT investment and robust processes have to be initiated at every stage of the chain.



Substantial changes in operating processes

The new initial response in terms of OTC derivatives will henceforth consist in distinguishing between so-called standard OTC derivatives, which are eligible for clearing, and non-standard OTC derivatives. For the latter, collateral exchanges will continue to take place bilaterally between the two counterparties, although with increased requirements in terms of the amount that must be collateralised ('margin').

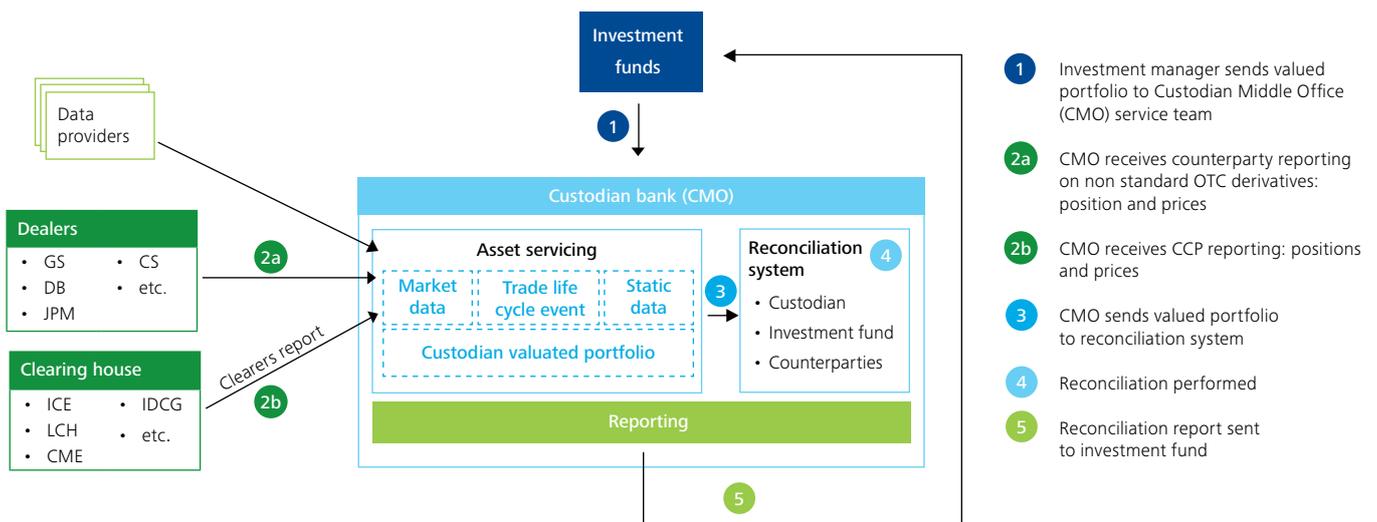
Standard OTC derivatives on the front line in terms of clearing eligibility are interest rate swaps (IRS) and credit default swaps (CDS), which are essential to fixed income portfolio management, whether it be to hedge interest rate and credit risks or to implement alpha-generating strategies.

Previously, there was generally a monthly exchange of collateral for a CDS. From now on, daily collateral exchanges will be required ('variation margins'). Also, asset managers' funds will probably continue to deal with the same counterparties as before for IRS and CDS, with the difference being that most major players, such as Barclays, Goldman Sachs, etc., will now also be clearing agents who will have to interface with one or more clearing houses. They will have to confirm trades carried out on affirmation platforms. They will then be able to choose between internalising a process and delegating it to their custodian bank. In the case of the latter, they will have to either be logged on these affirmation platforms or be informed by the asset management firms, with the last option probably being the least pertinent. It would then be the responsibility of the custodian bank to execute the payments/receipt of daily requests carried out by the clearing agents employed by the clearing houses.

Although easy to describe, the process is only possible with substantial IT investment, which will allow for, in addition to the daily trade flows, a strengthening of the reconciliation and control processes and the production of consolidated reports, which will from now on distinguish between cleared and non-cleared OTC derivative positions. In order to meet the new

constraints imposed by EMIR and Dodd-Frank, reconciliation services will now also have to be carried out frequently and will be all the more robust given that they will be based on at least three different sources: the asset managers, the dealers/clearers and an independent agent who provides a position-keeping service and an independent valuation service.

Valuation and reconciliation: Target process

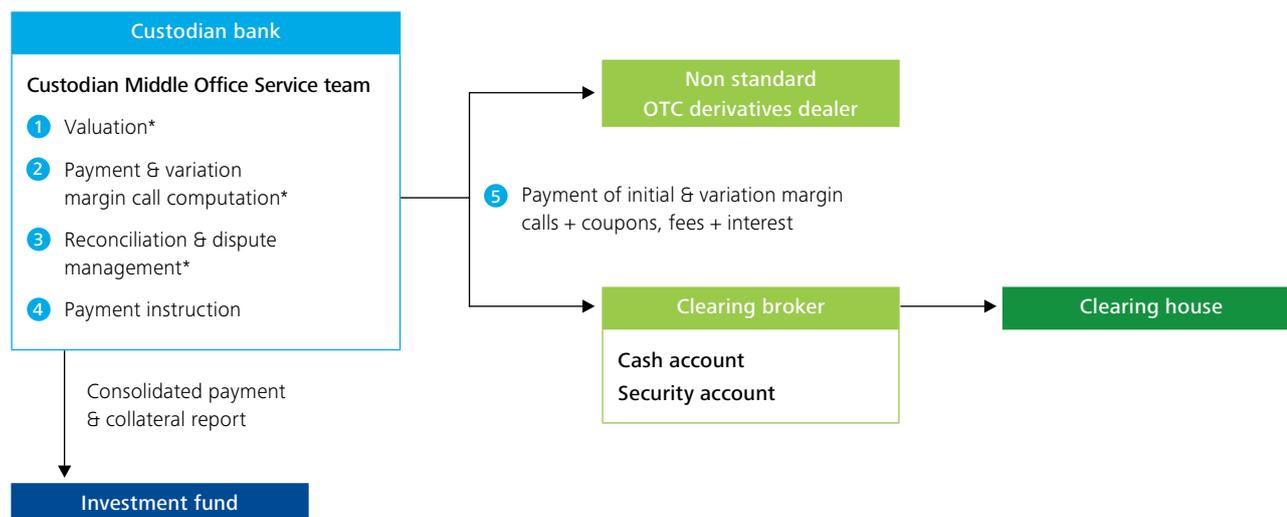


For custodian banks, the challenge is to build suitable high-performance infrastructures capable of supporting a much higher and more complex daily volume



The situation will also be more complex in terms of payment and collateral exchanges, because it will now mean carrying out 'netted' exchanges to various players on a daily basis. Furthermore, these will no longer be purely cash exchanges, but could also include securities. The custodian bank will then be responsible for ensuring the transfer of securities in accordance with the eligibility rules of each clearing house and counterparty.

Payments and collateral: target process



* For non standard OTC derivatives

For asset management firms, all of this will entail substantial adaptation, both in terms of management and in terms of operations. How successful such companies are in achieving this will no doubt have an impact on performance. For custodian banks, the required efforts will be no less substantial and, on top of the required IT investment, the goal will be to continue favouring an increase in client assets by creating infrastructures and processes that are adapted to asset management strategies that incorporate OTC derivative instruments.

The initial margin is a permanent additional collateral buffer in the form of cash or securities, the value of which is regularly reassessed

To the point:

- In Europe, the regulatory framework for OTC derivatives is far from being stabilised, despite the EMIR final vote in May 2012
- The nominal amount of collateral required should double by 2013, whilst collateral movements should increase seven-fold
- The systematic introduction of initial margins in addition to variation margins undoubtedly complicates the task of asset managers and optimising as well as transforming a fund's assets liable to be used as collateral become key questions
- The EMIR and Dodd-Frank reforms are incurring substantial changes in operating processes and for custodian banks; the challenge is to build suitable high-performance infrastructures capable of supporting a much higher and more complex daily volume

ECJ Santander and Aberdeen cases

From tax level playing field to operational nightmare

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Introduction

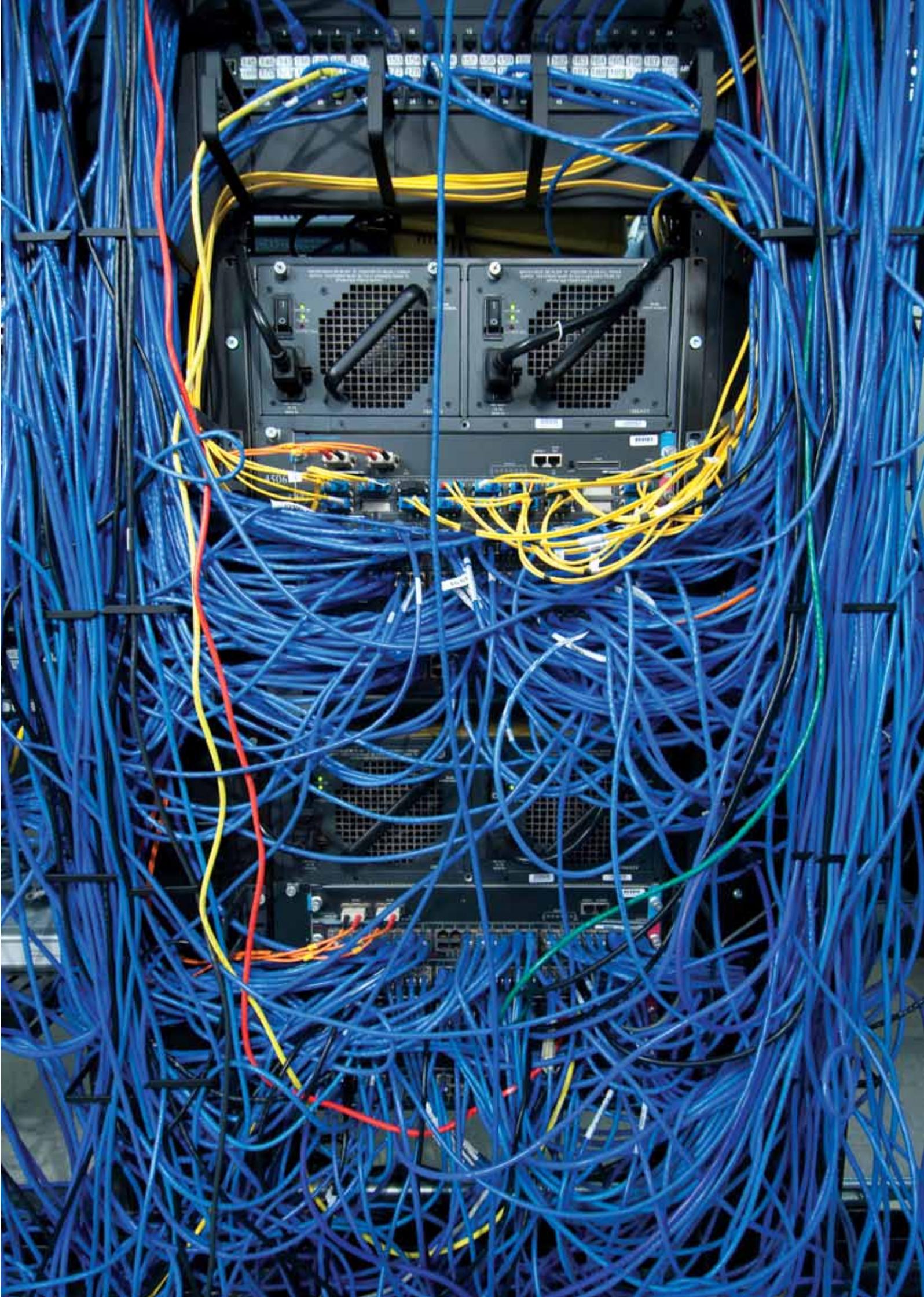
Reclaims of withholding tax on dividend income based on the European Court of Justice (ECJ) decision in the Aberdeen case¹ (C-303/07) are still possible for investment funds across 13 different Member States which applied or are still applying discriminatory rules towards non resident investment funds (Belgium, Estonia, Finland, France, Germany, Hungary, Italy, Netherlands, Norway, Poland, Romania, Spain and Sweden).

Naturally, each of the 13 Member States eligible for withholding tax reclaims has its own statute of limitation and its own underlying data and documentation collection requirements.

Lodging these reclaims involves a specific and significant data collection process in order to provide the local tax administrations with a reclaim file tailored to comply with all local requirements. These local ad-hoc requirements are very different and much more demanding than those applied to standard Double Tax Treaty tax reclaims, for example.

The need for data reconciliation between the depositary bank and the sub-custodians to ensure perfect data accuracy generates a considerable workload and requires excellent coordination and strong communication among all stakeholders.

¹ Case C-303/07 Aberdeen Property Fininvest Alpha Oy



These stakeholders are either domiciled in the same Member State as the investment fund—the investment vehicle filing the reclaim and the local depositary bank (which will provide the quantitative information related to the events underpinning the reclaim)—or in the Member State of the investment—the local sub-custodian and paying agent (to provide documents evidencing the dividend/interest payments at all steps of the custody chain) and the tax practice (which will file the reclaim and advise on its content and form).

The decision taken by the fund manager to file the tax reclaims requires the participation of experienced resources from a large number of local and foreign stakeholders.

Over recent years, Member States under the pressure from the European Commission, have amended and continue to amend their tax rules to eliminate previously discriminatory tax rules. Therefore, with time, fewer opportunities will remain available for those fund managers who have not yet filed the appropriate tax reclaims within the local statute of limitation.

Experience has shown that the operational nightmare can be put to an end when fund managers appoint teams of experienced service providers as business partners to assist them with the task of filing multi-jurisdiction tax reclaims. These include custodian banks, specialised tax advisors with broad pan-European tax knowledge and networks, and project managers who will ensure smooth communication among all project stakeholders while heavily decreasing the need for dedicated resources by the fund managers filing the reclaim.

The path to the ECJ Santander case

The ECJ has heard cases in the field of direct taxation for more than 40 years. The Luxembourg-based court consistently ruled that although direct taxation falls within the competence of the European Union Member States, Member States must exercise this competence in compliance with community law. More precisely, they must be consistent with the four fundamental freedoms of the Treaty of the Functioning of the European Union (TFEU): free movement of goods, free movement of persons, freedom to provide services, and free movement of capital.



The ECJ has heard cases in the field of direct taxation for more than 40 years

Over time, the investment fund industry has become aware of the EU law's impact on the taxation of cross-border portfolio investments. The necessity to consider this and act, in the light of restrictive measures in the European Union being applied to EU based investment funds, was soon identified by depositary banks, management companies and board of directors of investment funds as part of their fiduciary duty to act for the benefit of their investors. As a result, the last five years have seen an increasing number of protective claims filed by EU-based investment funds requesting refunds of unduly levied withholding taxes on EU portfolio investments².

In addition to this, the latest ECJ case joined Cases C-338/11 Santander Asset Management SGIIIC SA v *Directeur des résidents à l'étranger et des services généraux* and C-339/11 to C-347/11 Santander Asset Management SGIIIC SA and Others v *Ministre du Budget, des Comptes publiques, de la Fonction publique et de la Réforme de l'Etat* (Santander Case) —similarly to the ECJ Aberdeen case of 2009, is of significant interest to both EU based investment funds and non-EU investment fund managers.

Can non-EU investors file reimbursement tax claims along with EU investors?

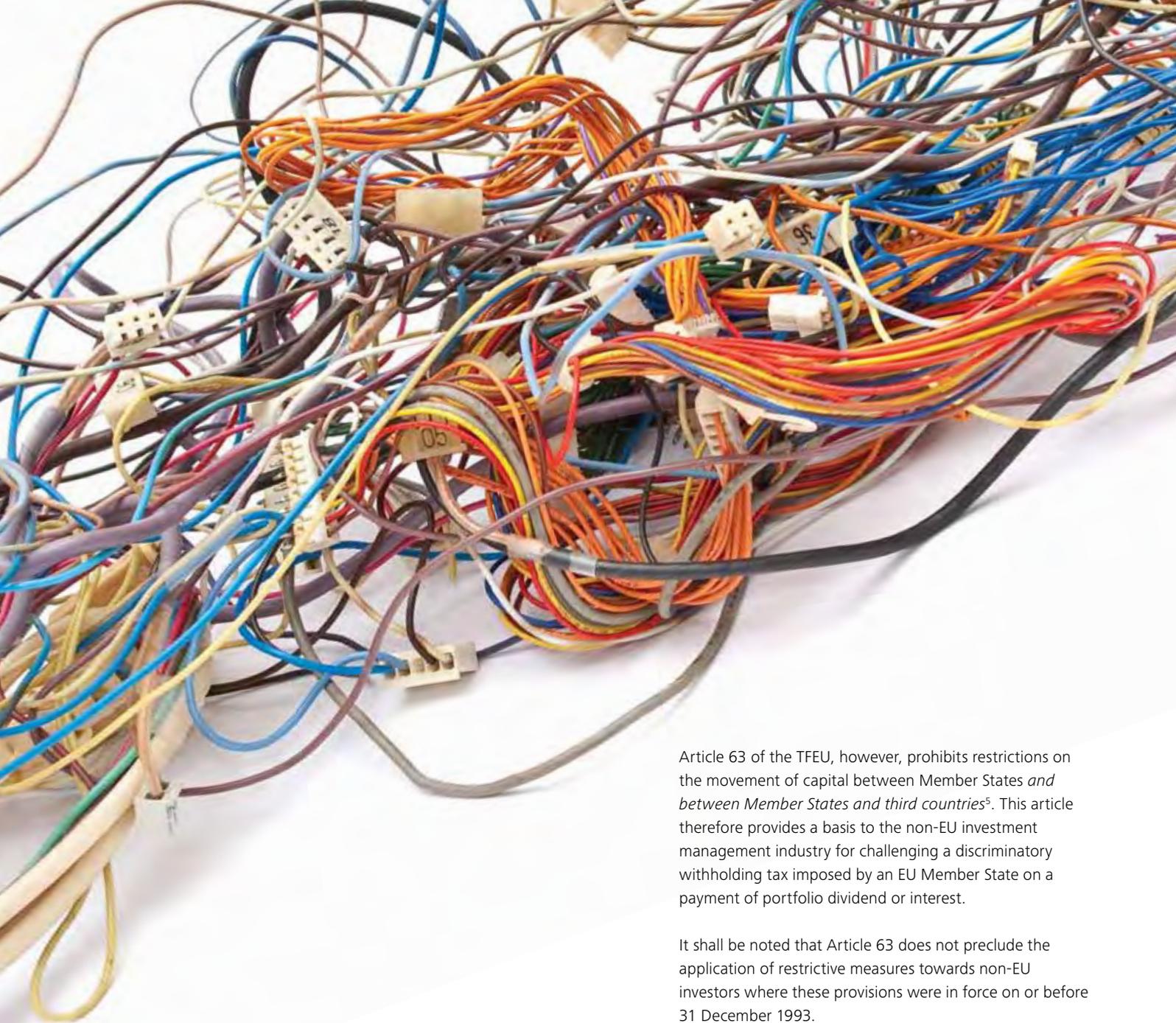
As mentioned above, Member States must exercise their taxation competences consistently with the TFEU³. The TFEU is aimed at ensuring free movement within the EU of goods (Article 34), persons (Articles 45 and 49), services (Article 56) and capital (Article 63).

Article 49 of the TFEU prohibits restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any member state established in the territory of any Member State—applies where, for instance, dividends are received by an investor of another member state from investments which confers to the investor definite influence over the company's decisions and activities ('direct investment')⁴. The reference to 'Member States' of Article 49 makes clear that that freedom of establishment could only be claimed by EU investors.

² On this topic also see the Deloitte's edition of *Performance*, Issue 3, September 2010

³ Notably paragraph 19 of Case C-170/05 (*Denkavit*); paragraph 40 of Case C-196/04 (*Cadbury Schweppes*)

⁴ C-524/04 *Test Claimants in the FII Group Litigation*; C-157/08 *Halböck*



According to ECJ case law, a restriction to a fundamental freedom is permissible only if it is justified by overriding reasons in the public interest

Article 63 of the TFEU, however, prohibits restrictions on the movement of capital between Member States *and between Member States and third countries*⁵. This article therefore provides a basis to the non-EU investment management industry for challenging a discriminatory withholding tax imposed by an EU Member State on a payment of portfolio dividend or interest.

It shall be noted that Article 63 does not preclude the application of restrictive measures towards non-EU investors where these provisions were in force on or before 31 December 1993.

According to ECJ case law, a restriction to a fundamental freedom is permissible only if it is justified by overriding reasons relating to the public interest. Furthermore, it is necessary, in such a case, that it should be appropriate to ensure the attainment of the objective in question and not to go beyond what is necessary to attain this objective⁶—according to the principle of proportionality.

Therefore, the tax legislation of a Member State shall not impose a level of taxation on non-residents that is higher than on a resident investor in a comparable situation. When investing in the EU, non-EU investors should assess whether the combined effect of the tax rate, tax base, etc. regarding the relevant portfolio income (dividend or interest) entails a more burdensome level taxation for EU investors.

⁵ *Emphasis added*

⁶ see Case C 414/06 *Lidl Belgium* [2008] ECR I 3601, paragraph 27, and Case C 157/07 *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt* [2008] ECR I 0000, paragraph 40



Non-EU investors may have significant opportunities to file claims requesting refunds of unduly levied withholding taxes on EU portfolio investments in the following situation:

- The tax payer is resident in a third country (e.g. USA, Canada, Switzerland, Japan, or any other non-EU jurisdiction). Considering that under ECJ case law⁷ the absence of contractual obligation to provide information was retained as an acceptable restriction to the non-discrimination principle, it is commonly analysed that there should be a bilateral income tax convention for the avoidance of double taxation and tax evasion between the EU Member State and the third country
- A discrimination must exist under the tax law of a Member State on the taxation of portfolio dividends or interest made to non-EU, non-residents and residents
- Non-EU residents and EU residents must be in a comparable situation
- There should be no 'acceptable' justification to the discrimination that could be argued by the EU Member State

The Santander case

Over the past years the decisions of the ECJ⁸ have created the opportunity for the EU investment management industry to successfully obtain refunds of taxes for the benefit of the investors. As from 10 May 2012, these opportunities have been extended to third countries' investment funds (the parties of the case were investment funds located in the EU and in the United States against the French government).

In essence, the ECJ ruled that Articles 63 and 65 of the TFEU must be interpreted in the sense that domestic legislation cannot impose, through the application of a withholding tax, taxation on dividends paid to non-resident investment funds whilst exempting dividends paid to resident investment funds from taxation. Discrimination has been considered on fund level only and not on investor level.

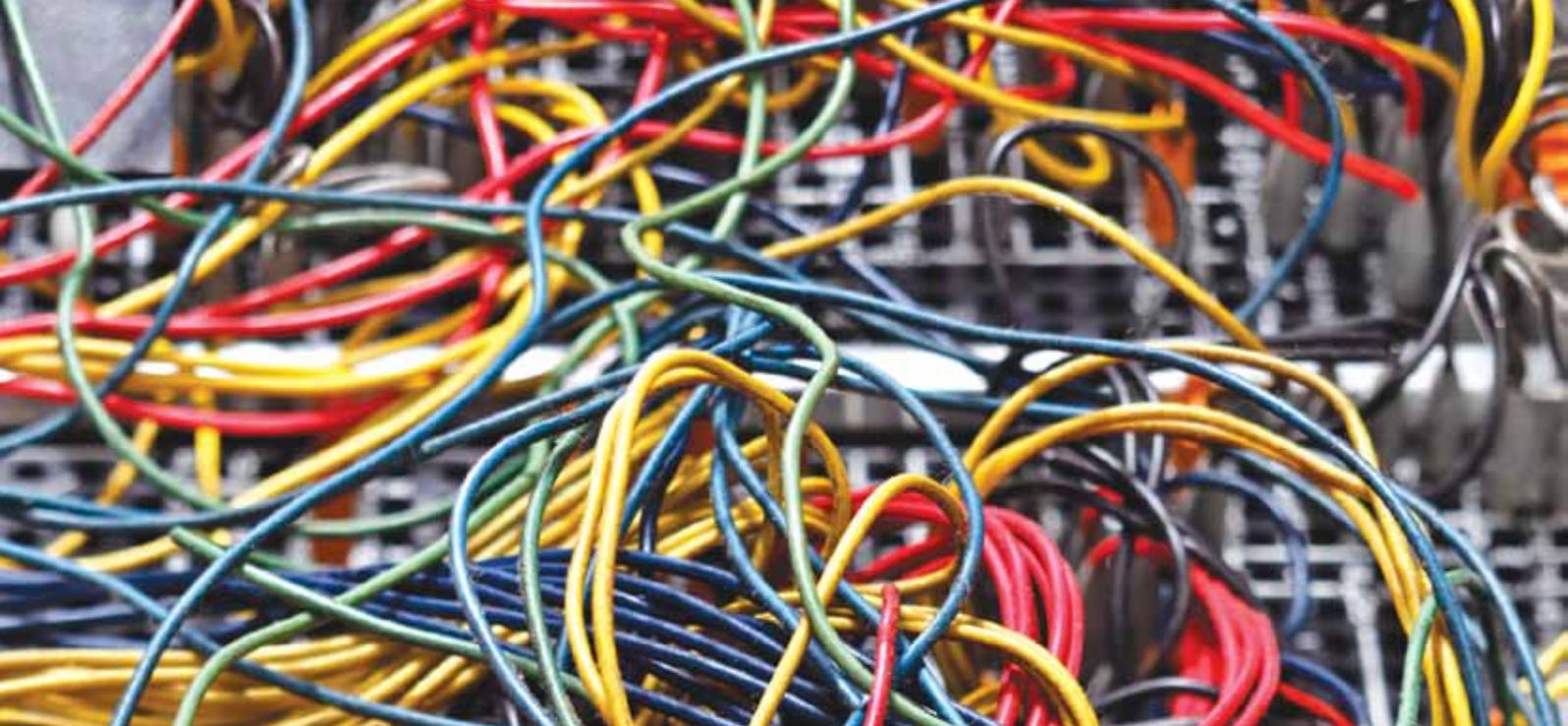
The ECJ began by pointing out that restrictions on the free movement of capital include any measures which discourage non-residents from making investments in a Member State or those which discourage residents of this Member State from doing so in other Member States. A difference in the tax treatment of dividends according to the investment fund's place of residence may discourage, on the one hand, non-resident investment funds from investing in companies established in France and, on the other hand, investors resident in France from acquiring shares in non-resident investment funds. Therefore the ECJ considers that the French legislation in question constitutes a restriction on the free movement of capital, which is, in principle, prohibited under EU law.

The question arising from this was whether such a restriction could be justified in the light of the provisions on the free movement of capital—a different treatment is only considered as compatible if it concerns situations which are not objectively comparable or is justified by an overriding reason relating to the public interest.

One of the very key questions addressed by this case was whether the ECJ would consider to take into account the situation of the shareholders—

⁷ A Case, C-101/05, Dec. 18, 2007

⁸ *Inter alia*, EFTA Court E-1/04 Fokus Bank ASA, 11/23/2004—it was decided that Norwegian withholding tax imposed on dividend payments to EU resident shareholders violated free movement of capital; ECJ C-101/05, A-Case, 12/18/2007—it was decided that Swedish denial to exempt dividends received from companies resident outside of the EEA violates free movement of capital; A&B Case, C102/05, May 10, 2007; Halbock case, C157/05, May 24, 2007; Commission vs. Italy, C540/07, November 19, 2009



the argument put forward by the French State – or whether only the situation of the residency of the investment funds should be taken into account—the argument put forward by the plaintiffs. The ECJ adopted the latter argument. For the purpose of determining whether this legislation is discriminatory, the situation must be compared to the investment fund only by reference, without taking into account the situation of its shareholders.

The Court went on to examine whether the different treatment could be justified by overriding reasons relating to the public interest. All the arguments put forward by the French State—the need to ensure a balanced allocation of the power to tax between the member states, the need to guarantee the effectiveness of fiscal supervision; and the need to preserve the coherence of the (French) tax system—have been dismissed by the ECJ.

The ECJ could not have ruled differently. EU law precludes the French legislation which taxes nationally sourced dividends at source when received by investment funds resident in another state but exempts these dividends from tax when received by investment funds domiciled in France.

EU Member States modifying their tax legislation

Following the ECJ and national courts' decisions as well as the measures taken by the European Commission, a few countries have modified their tax legislation in order to abolish discriminatory measures.

France is the latest Member State to propose amendments to its legislation—the second Amended Finance Act of 2012 approved by the Parliament on 31 July 2012.

The Amended Finance Act contains other modifications to the French law, however, in relation to investment funds the intention is to extend the exemption of dividend withholding tax to EU investment funds and investment funds located in countries that have signed a tax treaty with France which includes an administrative assistance clause.

In order to access the exemption the investment fund is required to raise funds from a number of investors to invest them according to an investment policy. The investment fund must have similar characteristics to those of a French investment fund.

Over the past years the decisions of the ECJ⁸ have created the opportunity for the EU investment management industry to successfully obtain refunds of taxes for the benefit of the investors

In order to compensate the loss of tax revenue as a result of this exemption, the French state has, nonetheless, introduced a 3% additional contribution levied on dividends paid out from French resident companies or French branches of non resident companies (specific exemptions apply).

Despite the increasing pressure from the European Commission and the ECJ, the changes in tax laws of the Member States remain fairly limited and discriminatory situations remain. The modifications implemented by the Member States tend to eliminate the restrictive rules in relation to UCITS-compliant funds whilst keeping in place these measures in relation to non-UCITS-compliant funds or investment funds located in third countries (this is currently the case of Spain, Poland, etc.)

Non-EU investors—the way forward

As was previously the case with discriminatory provisions affecting EU investors, the ECJ faces an increasing number of cases that are aimed at clarifying the treatment of third country portfolio investors in light of the free movement of capital. These decisions will undoubtedly impact the investment fund industry and will set the stage regarding the conditions for reclaiming withholding taxes for the coming years.

Given the economic and financial crisis impacting European countries, it is likely that the Member States will try to limit the application of the ECJ cases in order to avoid having to reimburse all the claimants.

For instance, close attention should be paid to the preparation of the reclaims (formally and substantially), otherwise reclaim rights could be easily denied by the local tax authorities. Based on past experience, carefully preparing the tax reclaim file to address the domestic

procedural formalities will be pivotal to the success of the claims (withholding tax reclaims involve a significant document and data-collection process).

Fund managers and custodian banks should assess the exposure of their investment portfolio to EU withholding taxes according to their contractual duties. In doing so, it is necessary to remember that no common approach exists among EU Member States regarding reclaim procedures as well as no common statute of limitation.

In any case, it is now clearer than ever that not acting, i.e. not correctly assessing the amounts at stake, Member States of investment, type of income received, cost-benefit analysis and the overall *de facto* situation, is not a viable option to pursue.

To the point:

- Reclaims of withholding tax under the so-called 'Aberdeen' case have increased significantly over the last year due to increased client awareness
- Fund board members and management companies also have a keen interest in ensuring that their fiduciary duties towards investors are evidenced by performing a review of potential amounts in scope
- Operational workload, combined with tax complexity make it a cumbersome exercise for custodians but with high potential return for the investors

FATCA

From worldwide imposed to bilaterally negotiated?

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1. Introduction – FATCA implementation on the IGA crossroad

As is well-known, the 2010 Foreign Account Tax Compliance Act (FATCA) will be applicable as from 1 January 2013. Foreign Financial Intermediaries (FFIs) worldwide will need to assess whether to enter into an FFI agreement with the IRS, knowing that not participating will, in many cases, not be an option in view of the punitive 30% withholding tax. In order to avoid possible exposure in the hands of an FFI to such punitive tax regarding its own revenue streams, an FFI agreement should be signed with the IRS before 1 July 2013 (the application process is expected to be opened as from 1 January 2013). Only in this case does the IRS guarantee that an FFI will be formally registered as a participating FFI before 1 January 2014 (i.e. before the first withholding phase kicks in).

Impact assessment and implementation projects carried out by the financial world have accelerated rapidly since the draft regulations were made available by the IRS in February this year. These draft regulations, which are (although still possibly subject to change), indeed contain sufficient detail to progress significantly with FATCA implementation projects.

However, another important development has seen a growing number of jurisdictions begin negotiations with the United States on alternative approaches to FATCA implementation. These alternative approaches are based on bilateral Intergovernmental Agreements (IGAs). In this article, we will comment on the reasons why certain states have started this process, what the main types of draft model IGA available or under construction are, how these various models compare, and what the advantages and disadvantages of such IGAs may be for the industry.



2. An alternative approach: IGAs

Complying with FATCA requirements may cause FFIs to incur significant compliance costs. Even more importantly, in some jurisdictions, FFIs might be at risk of breaching local data protection, anti-discrimination, confidentiality and banking secrecy rules if they comply with FATCA requirements. Finally, the 30% withholding requirement on pass thru payments to recalcitrant account holders or non-participating FFIs, to determine and publish the passthru payment percentage may give rise to significant technical issues.

As is well-known, the 2010 Foreign Account Tax Compliance Act (FATCA) will be applicable as from 1 January 2013

In light of these considerations France, Germany, Italy, Spain and the United Kingdom have agreed with the United States to explore a common approach to FATCA implementation through domestic reporting and reciprocal automatic exchange based on existing bilateral tax treaties. Switzerland and Japan have followed suit and entered into negotiations with the United States, according to the joint statements that have been issued, based on a different approach. Until now, almost 50 countries have expressed an interest in entering into IGAs with the United States. It would appear that IGAs currently under negotiation between the United States and the European FATCA partners plus Switzerland and Japan would be used as templates for future IGAs.

To become effective, the IGAs need to receive legislative approval, as does any other international convention. Then, the requirements of these IGAs need to be transposed into the local legislation of the respective FATCA partner states.

3. The European IGA model

The negotiations with the five above-mentioned EU jurisdictions resulted in two draft IGA models made available at the end of July 2012: a reciprocal version providing certain information sharing requirements for the United States on accounts held in the United States by residents of a bilateral partner; and a non-reciprocal version intended to be used with countries that have a double taxation treaty or an OECD model Tax Information Exchange Agreement (TIEA) in place with the United States.

Both models are based on automatic exchange of information mechanisms, allowing FFIs located in the bilateral partner country to report information on U.S. accounts to their local tax authorities. The latter will then forward this information to the IRS.

The mechanism is thus, in operational terms, similar to automatic exchange of information as applied under the EU Savings Directive, although the content is very

different. The exchange of information under the EU Savings Directive only relates to certain types of interest and distribution or redemption gains on certain types of investment funds considered as interest under this directive. FATCA, however, refers to all types of Fixed, Determinable, Annual or Periodical (FDAP) income (a broad notion which includes not only interest and dividends, but also rents, royalties, etc.) and proceeds from the disposal of assets generating such FDAP income. Additionally, under the EU Savings Directive, only the last active economic operator in a payment chain qualifies as the paying agent responsible for reporting, while under FATCA, the entire chain of economic operators involved needs to be compliant.

Under both models, FFIs will only be required to register with the IRS rather than entering into a full FFI agreement. In contrast to the full FATCA regime, FFIs in IGA partner countries will not need to withhold on recalcitrant accounts or close such accounts. Passthru payment withholding would also not apply.



4. The Swiss and Japanese approaches

The Swiss and Japanese IGA framework did not crystallise in draft IGAs yet. What follows below is based only on declarations of intentions made by the involved countries.

Japan	Switzerland
<p>A framework would be agreed based on the existing bilateral United States—Japan Income Tax Convention.</p> <p>Remarkably, Japanese FFIs will be able to choose whether to enter into an FFI agreement with the IRS directly or simply to register with the IRS and, in the case of the latter, confirm they will comply with official guidance issued by the Japanese Financial Services Agency (FSA). The prescriptions to be issued by the FSA will include similar requirements to those of participating FFIs under FATCA, such as: (1) applying the due diligence rules to identify U.S. accounts; (2) annual reporting of the account information required, in the time and manner prescribed by FATCA rules, and send this information directly to the IRS, provided that the consent of the U.S. account holders was obtained; and (3) annual reporting of the aggregate number and values of accounts held by recalcitrant account holders to the IRS.</p> <p>Furthermore, Japan would need promptly to honour any group requests made by the United States for additional information on accounts reported as recalcitrant by Japanese financial institutions, in accordance with the 'information exchange upon demand' provisions of the United States—Japan Income Tax Convention.</p> <p>The framework would not require the United States to agree to reciprocate information reporting. However, the United States would agree to identify Japanese financial institutions that would be treated as deemed compliant or exempt and eliminate the United States from withholding on payments to financial institutions in Japan.</p>	<p>Similar to the solution with Japan, the cooperation between Switzerland and the United States will follow the intergovernmental approach and will be built upon the already existing relationship in tax matters between the United States and Switzerland.</p> <p>In a bilateral cooperation agreement, Switzerland would agree to instruct Swiss financial institutions to sign an FFI agreement with the U.S. IRS. In order to comply with the obligations prescribed by FATCA rules, the Swiss authorities would commit to avoid conflicts with Swiss banking secrecy requirements by granting an exception in the Swiss criminal code.</p> <p>Furthermore, the Swiss authorities will accept and promptly honour foreseeably relevant requests by the U.S. competent authority for additional information about accounts identified as recalcitrant.</p> <p>The U.S. part of the IGA covers the obligation to identify specific categories of Swiss financial institutions or schemes that would be treated as deemed compliant or exempt.</p> <p>The framework and the cooperation agreement would result in the requirements to terminate the accounts of recalcitrant account holders and to impose foreign passthru payment withholding on payments to such account holders being repealed.</p>

Until now, almost 50 countries seem to be interested in entering into IGAs with the United States

5. A comparison of IGA models

Based on the European IGA model and the declared intentions regarding the Swiss and Japanese models, the most significant differences across these models are expected to be as follows:

	European IGA model	Swiss cooperation agreement	Japanese framework
Do FFIs need to conclude an FFI agreement with the IRS?	No, only registration with the IRS	Yes	Choice between registering and entering into an FFI agreement
Are additional exemptions determined?	Specific deemed compliant or categories presenting a low risk of tax evasion will be identified	Same, with few examples given, such as certain small, local Swiss FFIs and Swiss pension system institutions	Same, with few examples given, such as certain Japanese pension funds
Information exchange upon demand on recalcitrant accounts	No reference to additional information requests	Foreseeably relevant ¹ requests will be honoured	Information requests will be honoured
30% withholding on payments to local FFIs	Excluded, as all FFIs would be identified as participating FFIs or deemed compliant	Same principle	Same principle (if FFIs entered into an FFI agreement, or deemed compliant/exempt under the framework)
Passthru payment withholding applied by local FFIs	No, neither on payments to recalcitrant account holders, nor on payments to other FFIs located in same jurisdiction or in other jurisdiction with which U.S. concluded an IGA	Same, also explicitly confirming that FFIs will not be obliged to terminate accounts held by recalcitrant account holders	Same, also explicitly confirming that FFIs will not be obliged to terminate accounts held by recalcitrant account holders

Based on the above, although the principles under the European IGA model are to a certain extent similar to those under the Swiss and Japanese declarations of intent, there are differences as well. Additionally, in view of the differences between the Swiss and Japanese declarations, it can reasonably be expected that three, or even more, different IGA models may result from the negotiations with these and other interested countries, given that all EU Member States and several other jurisdictions have at least enquired about the IGA process, are considering starting negotiations with the United States, or are in the negotiation phase.

¹ Thus making reference to the terminology used within the context of exchange of information upon demand procedures according to OECD principles



6. Conclusions: advantages and disadvantages of IGAs versus FATCA regulations

The most important benefits of IGAs may be a mix of the following elements:

- The legal certainty granted to FFIs located in the respective FATCA partner countries. Relevant U.S. information might indeed be reported by FFIs to local tax authorities under automatic exchange of information or, where there is still direct reporting to the IRS, potential conflicts with local privacy, banking secrecy or other rules prohibiting delivery of U.S. information to the U.S. tax authorities will at least be avoided
- The fact that under certain IGAs, FFIs would not be obliged to enter into an FFI agreement. In this case, local legislation will apply in their relations with local tax authorities (without direct commitments towards or potentially complicated conflicts with the IRS to be managed). Additionally, there would be no requirement to appoint a responsible officer, guaranteeing the application of FATCA towards the IRS
- Certain additional deemed compliant and exempt categories may be determined on a country-by-country basis, thus potentially simplifying classification rules to be applied by FFIs. Additionally, an amended FFI definition may allow the exclusion of certain unregulated holding companies from the notion of FFI
- FFIs located within FATCA partner states will be guaranteed not to be subject to the punitive 30% withholding tax on their revenue streams and would generally not be obliged to levy such tax on payments to recalcitrant account holders, other domestic FFIs or FFIs in other states which have an IGA in place. No application of passthru payment withholding is currently foreseen under the IGA
- Additional time (6 months) may be allowed to register and implement reporting systems (2015 instead of 2014)
- A closer link with AML/KYC rules may become applicable (e.g. substantial U.S. owners identification may be based on the local 25% AML/KYC threshold instead of the 10% FATCA regulations threshold, there may be no need to update AML/KYC documentation only for FATCA purposes)

The most important disadvantages or neutral elements of IGAs could be:

- The fact that IGAs will contain customised sections, with potential differences between all IGAs that will be concluded. It goes without saying that this might lead to complications for FFIs doing international business and needing to handle these differences, in addition to the current uncertainty as to how to apply a mix of IGAs and full FATCA regimes in a cross-border context
- Additional exchange of information upon demand regarding recalcitrant account holders to be managed by the states and responded to by the FFIs
- Compliance requirements regarding identification would remain similar to some extent to those under the ordinary FATCA regime, meaning FFIs will still be required to identify U.S. accounts and to ensure sufficient systems are in place to track and report FATCA relevant information
- Last but not least, a critical timing element resulting from the IGA process as IGAs need to go through legislative approval procedures and need to be transposed into local legislation, which is extremely challenging in view of the entry into force of FATCA on 1 January 2013 and the fact that interested countries are in different stages in the negotiation process, with some still deciding and others in early or more advanced negotiations

Until now, almost 50 countries seem to be interested in entering into IGAs with the United States

While the IGAs do provide a significant number of advantages, it is not yet clear whether the implementation costs would be lower in cases where an IGA is concluded, as additional complexities may have to be managed by FFIs operating in a cross-border context.

To the point:

- Instead of accepting FATCA as it has been presented by the United States in 2010 more and more countries seek to enter into specific agreements with the United States to alleviate the impact of the regime on FFIs respectively NFFEs
- Inspired by German, UK, Italy, France and Spain, Switzerland and Japan entered into negotiations with the United States and have demonstrated that country specific requirements might be respected and should not be an obstacle for signing such agreements
- IGAs, of course, may mitigate legal risks related to FATCA compliance, may simplify administrative procedures but do not necessarily reduce costs of FATCA implementation as relevant U.S. information might indeed be reported by FFIs and U.S. accounts need still to be identified
- Despite all positive aspects IGAs might bear the risk of creating a vast number of 'tailor made' FATCA regimes and like this to increase the complexity of FATCA as such



Responding to the new reality Alternative Investment Fund Managers Directive Survey

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The Alternative Investment Fund Managers Directive (AIFMD) was born out of the financial crisis and drafted amid a storm of controversy that continues to rage.

For the first time managers of non-UCITS funds, both onshore and offshore, will be required to seek authorisation under a new and comprehensive EU regulatory framework. They will have to comply with a whole range of regulatory, organisational and operational requirements with far-reaching business consequences.

AIFMD must be implemented nationally by July 2013 and managers falling within its scope will have a further 12 months to comply – a short timeframe, given the scale of change required. As organisations move towards implementation, Deloitte conducted a survey

of investment managers to assess current industry sentiment and determine how managers plan to respond to the new regime. The survey findings reveal that most managers generally view AIFMD as a business threat and think the new regime will make the EU industry less competitive and more sheltered. Smaller managers, private equity and real estate are more likely to see AIFMD as a business threat. Those companies that regard AIFMD as an opportunity tend to be larger with an existing focus on onshore, regulated funds. Individual managers are taking different approaches to AIFMD, which is perhaps to be expected across such a diverse sector.

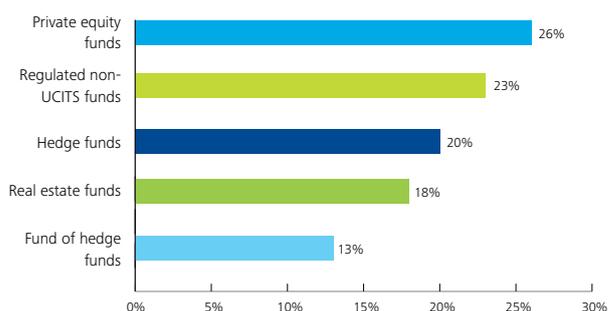
Five key themes emerging from the survey

- 1 Smaller fund managers, private equity and real estate are more likely to see AIFMD as a business threat.
- 2 Larger fund managers with onshore funds are more likely to view AIFMD as a business opportunity and take advantage of the EU passport.
- 3 The number of non-EU managers operating in the EU is likely to fall.
- 4 The European alternative investment fund industry is likely to be less competitive.
- 5 EU managers will continue to use both offshore and onshore products depending on the scenario.

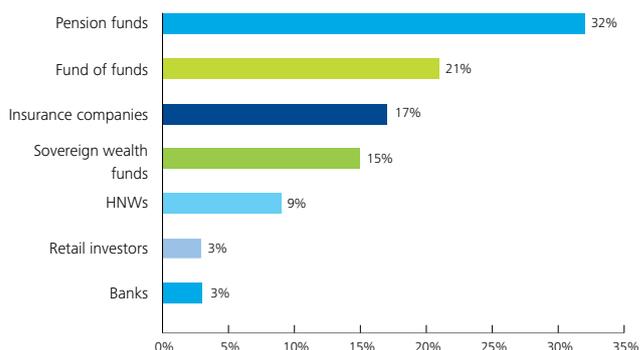
The survey was conducted in May/June 2012 of UK based asset managers from across the hedge fund, private equity and real estate sectors. The respondents collectively manage over £175 billion and are evenly distributed across these three segments.

Respondent profile

Business area



Most important investor groups



Key findings

A less competitive 'Fortress Europe'?

Many commentators have suggested that AIFMD is a building block of 'Fortress Europe'—a more protective European market sheltered from competition. The survey findings support this view, as 68% of respondents believe that AIFMD will lead to fewer non-EU managers operating in the EU.

The new regime may prove too onerous a compliance burden for some non-EU managers relative to their interest in the EU market. This may result in fewer non-EU managers operating in Europe and, combined with the exit of some EU managers, could lead to a significantly smaller number of players in the European market. Opportunistic managers are seeking to take advantage of this anticipated reduction in competition. 68% also believe that AIFMD's compliance burden

will reduce the competitiveness of the EU's alternative investment funds industry. In particular, larger managers are looking to take advantage of the reduced level of competition to grow their business.

Investor interests

Enhancing transparency towards investors is among the principle aims of AIFMD and in this the Directive looks set to succeed, not just due to the investor disclosure provisions. Over half of respondents plan to provide investors with additional information as a result of AIFMD's regulatory reporting requirements. This may, for example, include disclosure of all indirect transaction costs and further risk data.

However, the findings also suggest that increased transparency and investor protection may be counterbalanced by less choice and competition in the market, increased expense ratios, confusion over leverage figures and longer redemption terms in some cases. Nearly one quarter of managers expect AIFMD to have an impact on redemption terms and over half of respondents believe that leverage figures will 'cause confusion among investors'. A key challenge here for managers will be communicating these changes effectively to their investors.

Polarisation

The findings show that there is a polarisation of opinion among managers on AIFMD. Smaller fund managers and those focussing on private equity and real estate tend to take a more negative view of the Directive. This perhaps reflects the limited capacity of these managers to take advantage of the pan European marketing and management passports while also having fewer internal resources to deal with the initial and ongoing compliance responsibilities.

Larger fund managers, particularly those with a focus on 'regulated non-UCITS', are more likely to see business opportunities in AIFMD. These managers plan to use the EU passport to extend their fund distribution, enhance investor confidence through AIFMD-compliant funds and take advantage of any reduction in competition within the European market.



Betting on private placement and third country cooperation

61% of managers surveyed claimed that AIFMD will affect their choice of fund domicile, with the majority of these managers looking to continue establishing funds outside the EU or move funds offshore. It is therefore expected that managers will continue to set up both offshore and onshore regulated funds according to specific requirements and investor preferences.

Continued access for non-EU funds and managers is dependent on the signing of supervisory and exchange of information cooperation arrangements between all jurisdictions involved. There remains considerable uncertainty over the timely signing and practical operation of these cooperation arrangements as the European Securities and Markets Authority (ESMA) continues to negotiate with the key jurisdictions involved. Importantly, managers are placing considerable faith in the unhindered continuation of private placement via the EU's proposed cooperation arrangements.

Net business threat to the industry as whole

Given the widespread concerns with the Directive and Level 2 measures, it comes as no surprise that a sizeable majority (72%) of respondents view AIFMD as a business threat. The biggest concerns for fund managers are depositary costs (84%), delegation (78%), changes to contractual arrangements, routes to market and remuneration (67%).

Unsurprisingly, the depositary costs associated with AIFMD are the most pressing concern. Many managers will need to appoint a depositary for the first time

and will face additional fees from depositaries for the safekeeping and oversight of assets falling under the strict and potentially expensive liability provisions.

These costs could also rise further depending on the treatment of collateral under the depositary liability provisions in the Commission's final regulation.

The Commission's draft regulation has added additional criteria that would set a quantitative limit on the tasks that the AIFM can individually delegate whereby these must not substantially exceed the tasks remaining within the AIFM. This is a significant change from current management company models based on the retention of control and oversight within the AIFM and the delegation of day-to-day activities to the portfolio manager and service providers. Under the Commission's approach, the viability of internally managed funds may be called into question without significant insourcing. Managers may also be restricted in terms of the extent to which they can sub-delegate portfolio management.

Two thirds of respondents are concerned about routes to market post AIFMD and the phasing out of private placement. Once the transitional implementation period ends in July 2014, private placement will no longer be available to EU managers marketing EU funds in Europe, but the mandatory switch to an EU passport should enable continued distribution access within the EU. Managers with non-EU funds face greater distribution uncertainty and it therefore comes as no surprise that two thirds of respondents are also concerned about the so-called third country provisions.

Pension funds, insurance companies and sovereign wealth funds are among the industry's largest clients

The provisions on remuneration are also of significant concern to over two thirds of respondents. ESMA's guidelines on remuneration are likely to present a marked change for many AIFMs, even once the principle of proportionality is applied. Accordingly, managers need to carefully consider the implications of these requirements. Significant changes may be required in the way AIFMs remunerate 'Identified Staff',

with increasing emphasis on deferral into appropriate instruments and the introduction of retention periods. Consideration will need to be given both to meeting these requirements and managing the commercial impact for AIFs and individuals as well as the tax position.

These changes, combined with the organisational, contractual and operational realignment required under AIFMD, will have significant business impacts. Some respondents commented that AIFMD will simply add extra costs for no benefit while others were supportive of the Directive's original aims but felt the text took the wrong approach. There was widespread frustration with the rulemaking process and the uncertainties that have prevailed since the first draft, which respondents considered contrary to the interests of investors.

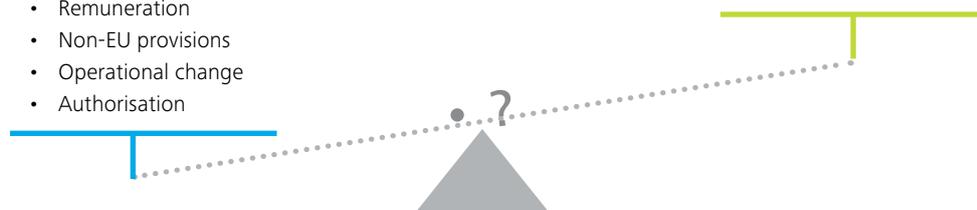
AIFMD threats and opportunities

Threats

- Depository costs
- Delegation and substance
- Market routes/end of private placement
- Contractual changes
- Remuneration
- Non-EU provisions
- Operational change
- Authorisation

Opportunities

- Distribution/EU passport
- Investor confidence
- Reduced competition
- Level playing field
- Brand creation



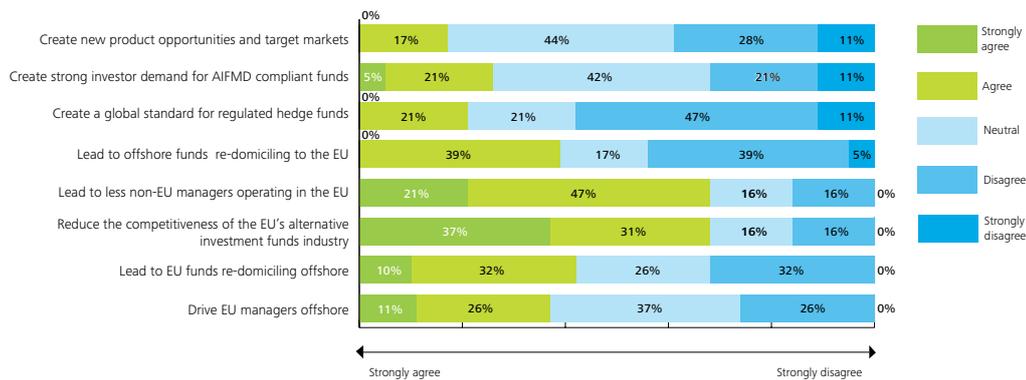
Perhaps most interesting is that 28% of respondents saw AIFMD as a potential business opportunity. While this group remain concerned about various aspects of AIFMD, most are seeking to utilise the new EU passport to extend distribution and would consider using the management company passport to rationalise operations.

Pension funds, insurance companies and sovereign wealth funds are among the industry's largest clients. Many of these entities will be subject to investment rules which favour AIFMD compliant funds (AIFs).

Under Solvency II, investment in AIFs may carry a lower risk rating and consequently provide a more cost-effective investment. Large governmental bodies may also be required to or prefer to invest in AIFs. Respondents managing regulated non-UCITS were more inclined to view AIFMD as an opportunity, as they are already active in the onshore, regulated funds domain.

Many of these respondents also see AIFMD as a means of enhancing investor confidence and consider that reduced competition from other players in the market may work to their advantage.

Implications for the market landscape



Comparisons with the success of the UCITS brand in the retail world have inevitably been drawn with AIFMD. However, a majority of 58% of managers surveyed do not believe that AIFMD will create a global standard for regulated hedge funds. Managers see continued use of well-established offshore routes and other domestic regimes for hedge funds, which will offer greater efficiency and flexibility with a lighter regulatory compliance burden.

Most respondents were undecided or disagreed with the proposition that AIFMD could potentially create new product opportunities in the same way that UCITS has done. However, the findings point to a sizeable market for AIFMD compliant funds, even if these funds do not achieve the same dominance in the alternatives world as UCITS in the retail world, with over a quarter of respondents anticipating strong investor demand for AIFMD compliant funds.

The findings suggest a range of responses with some managers moving more funds onshore, others moving their funds or entire operations offshore and the majority seeking to maintain the status quo for as long as possible while complying with AIFMD.

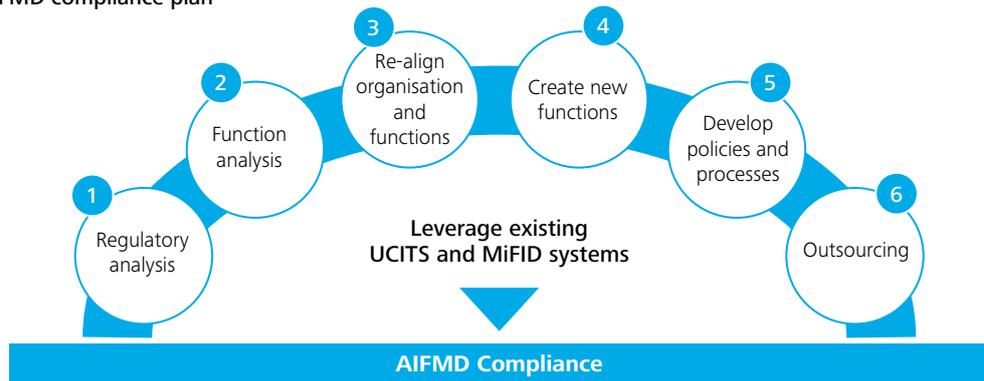


Positioning for the future

There is much uncertainty as to how the European market will look in six years' time when the transitional provisions relating to private placement are due to come to an end. However, it is clear that individual managers are taking different approaches to AIFMD, which is perhaps to be expected across such a diverse sector that encompasses everything from retail non-UCITS to offshore hedge funds.

Ultimately, there will be a trade-off for managers as to whether they want to remain in the EU or move offshore altogether, continue with private placement for as long as possible or operate fully under the EU passport to ensure unhindered access to EU investors. Each manager will have to determine their approach with regard to overall costs versus benefits, marketing strategy and investor requirements. The final outcome of the Commission's regulation and the third country cooperation arrangements will be an important factor in that regard.

AIFMD compliance plan



- Governance/organisational
- Authorisation/capital/PII
- Remuneration framework
- Marketing documentation
- Appoint depositary/address counterparty relationships
- Risk management/liquidity framework
- Valuation arrangements
- Reporting/disclosure

Given the uncertainty that has prevailed over the past few months in relation to the final implementing measures, managers will face tight timeframes in implementing the necessary organisational and operational changes. Larger managers will be better placed to absorb the implementation costs and are more likely to view operational realignment as a less daunting challenge. Scale will be a clear advantage when it comes to addressing the challenges and exploiting the opportunities of AIFMD.

However, even larger fund managers are concerned about the prospect of new delegation and substance requirements under the Commission's draft regulation,

as these changes may have a profound impact on current management company and outsourcing models. Can the EU passport compensate for the costs imposed by the Directive and will AIFMD become the global standard for regulated alternatives? The majority of respondents do not agree. After a brief period of decline, offshore centres are thriving again. The U.S. has not gone as far as Europe in its drive to regulate alternative investment funds and managers there, and in other large and growth markets, will not be subject to the same requirements.

However, the survey findings indicate that there will be significant, albeit not universal, demand for AIFMD compliant funds. With thousands of non-UCITS funds falling within scope, AIFMD is a force to be reckoned with. Ultimately, it is the investors who will decide AIFMD's success as a global brand. Much will also hinge on the final outcome of the detailed implementing measures and the third country cooperation arrangements.

Managers will face tight timeframes in implementing the necessary organisational and operational changes

To the point:

- More than two-thirds (68%) believe that AIFMD will reduce the competitiveness of the EU's alternative investment funds industry
- 68% also believe the Directive will result in fewer non-EU managers operating in the EU and 61% believe AIFMD will affect their choice of fund domicile
- 72% of surveyed managers view AIFMD as a business threat
- The biggest concerns for fund managers are depositary costs (84%), delegation (78%) changes to contractual arrangements and routes to market (67%)
- Smaller managers, private equity and real estate are more likely to see AIFMD as a business threat. Those companies that regard AIFMD as an opportunity tend to be large (managing at least £1bn of assets) and have an existing focus on onshore, regulated funds
- 41% of managers surveyed intend to take advantage of the EU passport to extend fund distribution

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ESMA issues response to the green paper on shadow banking

On 24 July 2012, the European Securities and Markets Authority (ESMA) published its response to the European Commission's green paper on shadow banking and it generally agrees with many of the views and opinions expressed by the Commission in the consultation.

ESMA broadly agrees with the shadow banking definition used by the Commission (i.e., 'the system of credit intermediation involving entities and activities outside the regular banking system'), however it considers that the definition should focus more on the activities performed rather than the entity performing the activity in order to ensure a consistent approach across sectors.

There is a risk of regulatory arbitrage by focusing on entities. In this regard, ESMA considers that it would be inappropriate to focus unduly on exchange traded funds rather than on shadow banking activities per se.

ESMA stresses that although shadow banking entails risks, this does not mean it is detrimental per se, but rather that it should have suitable regulation and supervision. ESMA agrees with the need for stricter monitoring, co-ordinated between relevant supervisors across financial market segments and, in this context, considers it crucial to have a 'flexible and evolving framework'.

ESMA indicated that securities lending and repo transactions (which are not included in the MiFID transaction reporting regime) are 'to some extent opaque to supervisors' with little available data and 'little or no regulation'. In ESMA's view, these issues could be remedied with (i) a more aggregated reporting regime and (ii) 'an appropriate and harmonised regulatory framework in the EU', through a standalone initiative or building on existing regulation.

The wake of UCITS VI

The latest consultation paper on UCITS published by the European Commission on 26 July 2012 is the next step towards a further enhancement of the UCITS product – namely UCITS VI. To explore available policy options, the Commission is looking for industry feedback across eight different areas, thematically distinct from upcoming UCITS V regulation. The main focus is on:

- The future regulation of Money Market Funds
- Efficient portfolio management techniques
- Counterparty risk for OTC derivatives
- Extraordinary tools to master liquidity bottlenecks
- Improvements of measures taken under the UCITS IV directive

The consultations are of particular importance for the established fund centres in Europe as they also address the introduction of an EU passport for depositaries. UCITS VI may have a large impact on the target operating model of depositaries should the existing link between fund and depositary domicile be softened.



IMD II, PRIPs and UCITS V: European proposals to enhance consumer protection

On Tuesday 3 July, the European Commission published three proposals as part of a consumer protection package: Packaged Retail Investment Products (PRIPs); a revision of the Insurance Mediation Directive (IMD II); and a revision of the Undertakings for Collective Investment in Transferable Securities Directive (UCITS V).

IMD II and PRIPs

The IMD II and PRIPs proposals introduce rules aimed at levelling the playing field for the sale and disclosure of insurance and retail investment products to strengthen consumer protection. PRIPs addresses disclosure rules for retail investment products and IMD II addresses sales and disclosure rules for insurance products, including additional sales rules for insurance investment products—insurance 'PRIPs'.

Both proposals represent significant strategic and operational challenges for providers and distributors in the insurance and retail investment markets. IMD II proposes to widen the scope of the Directive and strengthen conduct of business and professionalism requirements. PRIPs proposes the introduction of the Key Investor Information Document (KIID) when investment products are sold to retail consumers. IMD II and PRIPs, although separate proposals, are linked.

UCITS V

The UCITS V proposal sets out regulations and administrative provisions in respect to depositary functions, remuneration policies and sanctions relating to UCITS. It seeks to rectify existing discrepancies in rules relating to depositary regimes in the investment funds market to strengthen consumer protection.

There are three elements in this proposal:

- A new depositary regime which includes a clarification of the depositaries' duties, responsibilities and liabilities as well as a set of the rules under which tasks and responsibilities can be delegated—mainly focussing on the sub-custodian network
- Rules governing remuneration of key individuals (i.e. senior managers, risk takers and those who exercise control functions)
- A sanctions regime

Two detailed briefing notes have been published by the Deloitte EMEA Centre for Regulatory Strategy and can be viewed on http://www.deloitte.com/view/en_GB/uk/industries/financial-services/centre-regulatory-strategy/index.htm

Deloitte Named the leading global consultancy by revenue and strength of capability

Second consecutive year that Deloitte is recognized as the market leader in Kennedy's Global Consulting Marketplace report

Deloitte is pleased to announce that it has been named the leading consulting provider globally, based on 2010 aggregate revenue and strength of capability, in Kennedy Consulting Research & Advisory's Global Consulting Marketplace 2011-2014.

Deloitte was the only consulting provider recognized as having strong capabilities across all five of the service lines evaluated in the Kennedy report--strategy, operations management, IT advisory, HR, and financial consulting (which generally includes finance, risk, audit, and tax advisory services).

"At Deloitte, we define a market-leading organization as one that is responsive to stakeholders, drives quality and innovation, and whose commitment to global collaboration is reflected in its culture," said Barry Salzberg, Global CEO, Deloitte Touche Tohmatsu Limited (DTTL). "Kennedy's recognition of Deloitte as the consulting leader is testament to the experience, value, and commitment that Deloitte professionals bring to their client relationships worldwide."

"It's fair to say the world has been reset by a number of disruptive forces, each having a different impact across companies, sectors, and regions," said John Kerr, Managing Director, Global Consulting, DTTL. "Deloitte serves a diverse set of clients with diverse needs. Our unique ability to integrate a wide range of skills helps us respond with the right people, at the right place, at the right time."

Key findings:

"Deloitte's approach to serving its clients is to highlight the full breadth of its consulting services in strategy, operations management, IT, HR, and financial consulting."

"Deloitte's client relationships are strong across much of the C-suite due to the firm's strengths in IT and functional operations, especially among COOs and CIOs."

"Deloitte is actively expanding its talent base, increasingly hiring talent viewed as 'nontraditional,' such as people who have come out of a rigorous quantitative PhD program or who have substantial engineering and operations expertise. The firm has impressive plans to hire 250,000 new workers over the next five years, which includes nontraditional hires."

"We are enormously proud of what we've accomplished and the bar we've set for ourselves and others, but we have a saying at Deloitte: 'Proud but never satisfied,'" said Roger Dassen, Global Managing Director of Clients, Services & Talent, DTTL. "We continue to place great emphasis on the evolution and innovation of our business along many dimensions, as we realize that our success will be measured not only by our financial performance, but also by our positive impact on our clients, our people, and the communities we serve."

The report also highlights some of Deloitte's key strengths:

Depth of capabilities

"Deloitte's client service teams and target teams are assembling practitioners that make up a broad range of competencies to identify business issues (and solutions) that its competitors often cannot provide and sometimes the clients themselves have not considered."

"Deloitte is able to offer its clients a one-stop shop M&A consulting offering, which differentiates the firm in the marketplace. This includes access to Deloitte's in-house M&A advisor, Deloitte Corporate Finance."



Borderless approach to client engagements

"The firm uses a combination of international and local teams to serve clients, relying on the deep industry and technical knowledge of the global organization to get the right capabilities on the job fast and the in-country teams to ensure they are close to the client."

"Deloitte ensures breadth and depth in its capabilities with its 'As One' approach, reinforcing both the strength of its client relationships and the consistency in client engagements support within its global delivery model."

Targeted and integrated approach to clients' business issues

"Deloitte addresses the business and functional challenges of its clients by using an industry-centric approach. The firm targets specific industries and industry segments and develops consulting solutions that incorporate an in-depth understanding of the specific business dynamics, process and technology best practices, regulatory requirements, and organizational disciplines that drive each sector."

"To best meet client needs, along with its strong industry focus, Deloitte has global integrated market offerings that cross internal practice boundaries. This is intended to transcend the usual approach found in other consulting firms of having functional silos, which often dictates the offerings in any particular region."

This is the second consecutive year that Deloitte has been recognized by Kennedy in its annual Global Consulting Marketplace report. In its Global Consulting Marketplace 2010-2013* report, Kennedy named Deloitte the leading consultancy globally based on 2009 aggregate revenues.

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* As used in this release, Deloitte refers to Deloitte Touche Tohmatsu Limited member firms

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