cutting through complexity

FINANCIAL SERVICES

Evolving Investment Management Regulation

Navigating opposing forces

June 2015

KPMG International


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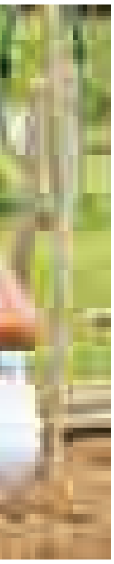

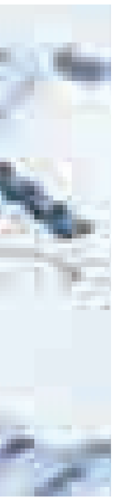

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Jeremy Anderson
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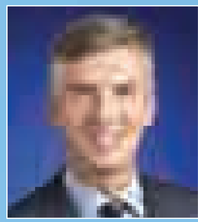


Tom Brown
Global Head of Investment Management

FOREWORD

Navigating opposing forces

This should be the golden age for the investment management industry. The combined forces of longevity, prosperity and demand for savings solutions are allied with growing demand for market-based finance, which creates a world of opportunities for investment managers. But firms must learn to navigate a regulatory environment that is pulling in different directions, changing customer aspirations and developments in the capital markets.

Since the financial crisis, an unprecedented volume of new regulation has been created and is now being implemented. Although the intent has mainly been positive, the execution has been cumbersome and often with un-intended consequences. Understanding and complying with so many new rules, some of which overlap or even conflict, requires significant resources and raises a number of business-critical decisions for firms.

Moreover, the regulatory headwinds are building. The industry has moved front of stage in the next phase of the policy debate and is being pulled in two directions. On the one hand, policymakers in many parts of the world are encouraging investment managers to help nurture and drive economic growth through initiatives to open up the capital markets as well as encouraging savers to invest for the long term. On the other hand, firms face further new rules and greater regulatory scrutiny as the industry's increasing size and breadth of activities are seen as a potential de-stabilizer in the financial markets and regulators fret about retail investors taking on too much investment risk.

A unique set of circumstances has thrust the industry to the forefront of governments' search for economic growth. First, the banking sector is unable to fulfil to the same extent its traditional financing role. Second, there remain large holes in national finances and countries are seeking an injection of private wealth to replace reduced public funding and increased, productive long-term savings. Third, fast-growing emerging markets need to develop their capital markets to ensure that growth remains strong and to gain their place at the top table.

Strategically, the industry is well-placed to play a key role: its purpose is to enable capital flow from those with money to save and invest to those who need financing. Also, it is a truly international industry whose services and products are sold across borders, languages, cultures and time zones.

However, precisely because of its geographical reach and its increasing size and range of activities, investment managers face considerable regulatory challenges. Regulators have legitimate concerns about reducing systemic risk, ensuring fair and orderly markets, and establishing an appropriate level of legal and regulatory protection for retail consumers. Meanwhile, the industry must also contend with and respond to questions about its charges and value for money, and ensure that its clients' assets are protected against growing threats.

Change is not easy, but we observe that forward thinking firms are engaging with the new environment. To enjoy this golden age requires positive dialogue with regulators and, most importantly, a focus on the fundamental purpose of the industry – linking enterprises seeking funds with helping people save and invest for the long term in an uncertain world.

EXECUTIVE SUMMARY

The investment management industry is ideally placed to facilitate capital flows and, thereby, economic growth. But being in the spotlight and at the center of the policy debate is also a burden. Policymakers' desire to see greater private investment and productive long-term savings, while mitigating systemic risk and embedding improved culture, creates a tension that will severely test the skills of firms' senior management.

So, how is this tension playing out? This edition of Evolving Investment Management Regulation focusses on the regulatory pulls and pushes that the industry is facing.

Under the spotlight

The potential designation of the largest investment managers and funds as "systemically important" now seems less likely, but **investment managers and funds of all sizes are under closer scrutiny**. Stable and orderly markets remain a priority, with both money market funds and bond funds being of particular regulatory focus. Also, supervisors around the globe are taking a more proactive approach to their day-to-day supervision of investment management firms.

Culture, conduct and conflicts

Regulators are intent on improving the culture of investment management firms. Understanding of the words "culture" and "conduct", and regulators' chosen approaches to them, vary, but some aspects are common. Firms are increasingly required to assume some responsibility for the supply chain – to oversee and actively monitor their counterparties, service providers and distributors. They must also focus on internal governance, the security of clients' assets, remuneration policy and value for money.

The overarching imperative is that, as agents, firms should act unambiguously in the interests of their clients and deal with conflicts head on. In particular, they must design and market products that offer real value and benefit to investors. Investment managers must be transparent and justify all costs and charges, including how they are set. In this and other regards, regulators are taking a strong stand.

Incentivizing private investment….

Policymakers, particularly in the West, are incentivizing private investment to fund fledgling enterprises and physical and social infrastructure. **Investment managers are being called on to facilitate capital flows into different types of assets**. And around the globe, new securities markets are opening up and new financing structures and fund products are being introduced. At the same time, however, many regulators remain cautious about ordinary citizens with modest savings investing in potentially "risky" asset classes. A number of regulators are turning their attention to the growth in crowdfunding and responsible stewardship remains on the regulatory radar.

….and long-term savings

The need for increased retirement savings remains at the forefront of policymakers' minds. A raft of changes to existing pension regulation are under discussion as well as the introduction of new pensions products and tax-free savings accounts. This will mean more assets for the industry to manage and opportunities to launch new fund-based retirement products. However, the result will be **even greater assets under management, creating further tension with regulatory debate over systemic risk**.

Distribution remains in flux

Some distribution barriers are falling, but others are rising. New fund passports are lowering cross-border barriers within regions, for instance, but raising them for foreign managers in those markets. Meanwhile, many **previously acceptable distribution practices are now unacceptable**, and regulators are pushing for greater and better transparency of costs and charges. In particular, the complexity of products sold in retail markets is under the microscope.

> "It is often said that banks are special. Compared to banks, asset managers generate a completely different risk and opportunity set. But they, too, are special both for the financial system and the wider economy. As they grow in scale and importance, that specialness is likely to increase further. The Age of Asset Management may be upon us."
>
> **Andrew Haldane**, Executive Director, Financial Stability, Bank of England, 4 April 2014

Step-change in reporting

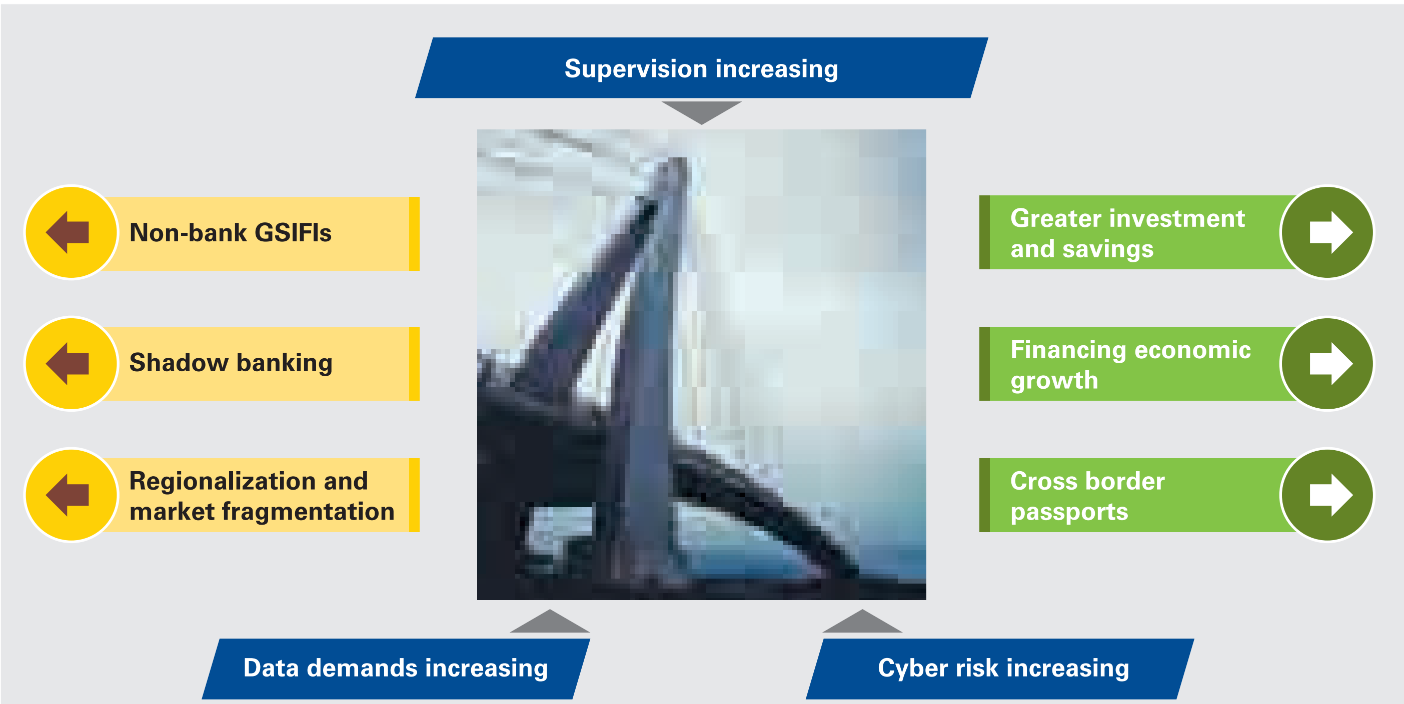
The regulatory data challenge for investment managers is significant and growing. One of the key success factors will be how firms handle data. Only in a small number of countries is the industry acting collectively. Firms can master their increasing data needs by **building a long-term data architecture strategy**, to move from incremental cost to embedded value. Once companies establish better data architecture and more mature analytics, they can then shape answers to business-critical questions as well as assuring their reporting obligations.

Cyber risk enters the mainstream

As the extent of cyber risk becomes increasingly clear, regulators and supervisors across the globe are responding. Company boards should be asking **key questions about the firm's cyber security policy and capability**.

Few investment management firms will be able to solve the current policy tension that permeates all their business activities, but many firms will, nevertheless, manage to thrive in the current environment. These firms will be innovative enough to take advantage of the many opportunities, and flexible enough to meet the data challenges head on.

Firms need to navigate regulatory opposing forces



Source: KPMG International, 2015

1. Investment management under the spotlight

Key points

- The potential designation of the largest investment managers and funds as "systemically important" now seems less likely.
- But investment managers and funds of all sizes are under scrutiny.
- Stable and orderly markets remain a regulatory priority, along with investment managers' conduct within them.
- Supervisors around the globe are taking a more proactive approach.

Early regulatory change in the post-financial crisis era focused on the wholesale markets, over the counter (OTC) derivatives and hedge funds. The debate on the structure of banks continues, but policymakers and regulators are now increasingly turning their attention to the investment management industry.

The potential designation of the largest investment managers and funds as "systemically important" now seems less likely. But investment managers and funds of all sizes are under scrutiny. A number of regulators are raising questions about the activities of investment managers and market stability. In particular, bond funds and loan funds are being singled out for closer regulatory attention. Also, orderly capital markets and the conduct of investment managers as users of those markets on behalf of their clients continues to be a regulatory priority.

Investment management and the systemic risk question

The debate over investment management and systemic risk has moved center stage.

The International Monetary Fund (IMF), the Bank for International Settlements, the Financial Stability Board (FSB), IOSCO[1] and the US Financial Stability Oversight Council have all reacted to the large increase in assets managed by investment managers, and to concerns that this could lead to big outflows from one or more asset classes in the case of market crisis.

An IMF report[2] in April 2015 urged authorities to press ahead with reforms of the investment industry. Building on IOSCO's framework paper for NBNI GSIFIs – non-bank non-insurance global systemically important financial institutions – the IMF argues for a proactive approach by policymakers.

Its concerns were echoed by Mark Carney, Governor of the Bank of England, who told the Davos 2015 conference that global regulators have cleaned up the banks and now have a new target in their sights. "The big question for us is about liquidity cycles that come from fund managers that do not have leverage," Mr Carney said. "It is USD 35 trillion of mutual funds that invest in relatively illiquid securities."

Meanwhile the IMF exhorts the US Securities and Exchange Commission (SEC) and the US Commodity Futures Trading Commission (CFTC) to continue to strengthen their ability to identify emerging and systemic risks. Enhancing mechanisms to ensure a holistic view of risks is recommended, in particular through each agency becoming more involved in assessing and monitoring responses to risks.

Just to make its message even clearer, the IMF's latest Global Financial Stability Report (GFSR)[3] includes an entire chapter on asset management and financial stability. It is the first instance of the GFSR including such a chapter, providing a clear indication of how fast the subject has risen up policymakers agendas.

The report provides clear insight into the future direction of regulation in the investment management sector. It observes that the sector will be a major channel of financial intermediation and recommends stronger micro-prudential supervision of asset management companies and macro-prudential oversight of the sector more generally.

This includes more intensive supervision, supported by global standards on supervision, better data, improved risk indicators (for financial soundness and liquidity) and stress tests.

It also includes consideration of how remuneration impacts systemic risk, including the potential imposition of

BREAKING NEWS

IOSCO announced on 17 June 2015, at its 40th Annual Conference, that it has concluded that a full review of asset management activities and products in the broader global financial context should be the immediate focus of international efforts to identify potential systemic risks and vulnerabilities. This review will take precedence over further work on methodologies for the identification of systemically important asset management entities. After the review is completed, work on methodologies for the identification of such entities will be reassessed.

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[1] International Organisation of Securities Commissions

[2] *Detailed Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation on the United States* – IMF, April 2015

[3] https://www.imf.org/External/Pubs/FT/GFSR/2015/01/pdf/c3.pdf

higher levels of disclosure. It believes the way fund managers are paid is a "key" contributing factor to price bubbles that inflate equity and bond markets. It says fund managers generate higher earnings and performance fees from asset growth, which incentivizes them to remain invested.

"The rise of the institutional investment management industry has coincided with three of history's largest bubbles in the last 25 years," wrote Brad Jones, an economist, in the IMF's working paper, Asset Bubbles: Re-thinking Policy for the Age of Asset Management[4]. The paper recommends reforms to asset managers' remuneration, including multi-year claw-back provisions, as per the banking industry. More emphasis should be placed on long-term performance and fund managers should be incentivized to deflate asset price bubbles, it said.

The IMF also wants to see greater focus on risk management, including liquidity requirements (for example, requirements for funds to hold minimum amounts of specific liquid assets), leverage caps, asset concentration limits, minimum redemption fees, exit gates, suspension of redemptions and fund share pricing rules.

It is not yet clear what the impact of this report will be. In many jurisdictions, such requirements have already been introduced or significantly expanded since the financial crisis.

How will systemically-important investment activities be identified?

In its consultation of January 2014, IOSCO sought to identify entities whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions.

The FSB in March 2015 set out revised proposals for identifying NBNI G-SIFIs[5], including both investment funds and investment managers. No individual entities have yet been designated as NBNI G-SIFIs, and there is no indication of the policy measures that would apply to these institutions, most if not all of which may be in the US. However, the FSB's thinking is instructive. It will initially assess firms with balance sheets of at least USD 100 billion of assets under management or more than USD 1 trillion, with different thresholds for investment funds. This means many countries' firms would not receive further consideration. However, some regulators – the Canadian regulator for one – are scrutinizing the liquidity of open-ended funds even though they are not close to the USD 100 billion threshold.

For entities above a threshold, the criteria will largely follow those already established for banks and insurers – that is, size, interconnectedness, substitutability, complexity and cross-border activities. Then, probably in 2016, firms will be allocated to lead national authorities to undertake an initial designation assessment, which would then be subject to cross-country and cross-sector consistency checks, and then to IOSCO and the FSB review. The speed of progress, however, is likely to be glacial.

The updated FSB proposals help to clarify what is meant by "systemically important", but do not develop the arguments about the potential systemic importance of investment managers or investment funds, as put forward most recently by Mark Carney and the IMF. In this sense, the investment industry could be forgiven for thinking it is trapped in a time warp. Indeed, as Andrew Haldane said in April 2014: "We are in the intellectual foothills when understanding and scaling transmission channels through which asset managers could generate systemic risk."

The investment manager and investment fund thresholds proposed by the FSB

Investment managers	Investment funds
1. Balance sheet of USD 100 billion or more; or 2. AUM of USD 1 trillion or more	1. USD 30 billion NAV and leverage of 3x NAV, plus any over USD 100 billion NAV; or 2. Over USD 200 billion gross assets, unless can demonstrate that not dominant player in its market

Source: KPMG International, 2015

Note: Assets Under Management (AUM), Net Asset Value (NAV)

[4] http://www.imf.org/external/pubs/ft/wp/2015/wp1527.pdf

[5] http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodolo

The US and Europe take different approaches on money market funds

In the **US**, money market funds (MMFs), once seen as vanilla investments, have become a focus for efforts to reduce systemic risk. Some invested in highly-volatile investments, leading funds to "break the buck" and investors to suffer large losses in 2008–09. The SEC's aim is to reduce the risk of investor runs on MMFs in times of financial crisis.

The cornerstone of the SEC reform requires institutional MMFs to "float" their net asset value per share (NAV), so that it reflects fair value of the investments in the fund. This is a significant change from the stable USD 1 per share NAV. Other provisions include the imposition of "liquidity fees" and "gates" on fund redemptions, increased disclosure on liquid asset levels, asset flows and market-based NAVs. The changes are being phased in, with the floating NAV and liquidity fee/redemption gate provisions taking effect in October 2016.

As a result, a number of funds are reorganizing, splitting up multi-class funds with both retail and institutional classes into separate retail and institutional funds. Others are involuntarily redeeming investors from single class funds. Many will need to evaluate the intermediaries they use to sell funds, and to understand their intermediaries' systems and verify there are controls in place to ensure the ultimate investor is a person, not an institution.

Meanwhile, **Europe** has grappled with the same issue and come up with a different solution, in part because the features of EU MMFs and their investor bases are a little different. Also, while the US has amended its accounting rules (and therefore the tax implications for investors) in tandem with the regulatory changes, in the EU accounting and tax rules are largely a matter for national governments.

The European Commission's proposal for a Regulation of MMFs covers both institutional and retail funds and contains a number of provisions, such as prescription on eligible assets, diversification requirements, liquidity ladder, disclosures to investors, a documented internal assessment procedure and stress testing. The industry is arguing that various provisions need refinement – such as those relating to valuation and the accounting methodology, and to internal credit ratings. Most importantly, although the proposal does not explicitly ban Constant Net Asset Value funds (CNAVs), it requires them to hold a 3 percent capital buffer, which would almost inevitably lead to their demise.

The European Parliament's Economic and Monetary Affairs Committee (ECON) has adopted amendments to the Commission's proposal. The text removes the death clause for CNAVs, in part as a consequence of corporate investors entering the latter stages of the debate. In contrast with the US MMF market, most EU MMFs are not marketed to individual investors.

Three types of CNAV are now proposed, all of which would be subject to additional provisions on liquidity fees and redemption gates (refer to box on the right).

The introduction of the new categories of CNAV funds may lead to further fragmentation of the MMF market in

Latest European proposal

Public debt CNAVs

must be **99.5** percent invested in public debt and by 2020 must be **80** percent-invested in EU debt.

Retail CNAVs

available to charities, non-profit organizations, public authorities and public foundations.

LV (low volatility) NAVs

the NAV may be rounded up or down by two decimal places in order to keep it constant. However, if the NAV deviates by more than **20 basis points** from the rounded constant NAV, the fund must stop rounding and publish the actual NAV.

Europe. Fund managers will need to develop different products, increasing their operational and administrative costs.

The European Fund and Asset Management Association (EFAMA) is not satisfied with the proposals as they stand. Low-volatility NAV funds would be subject to "stringent" regulatory requirements, such as applying a "sunset clause", which would mean they would cease to exist after five years. This, says EFAMA, makes the product unworkable for fund managers and unusable by longer-term investors, so is "at odds with the current policy focus of the Commission's Capital Markets Union initiative", which seeks to promote alternative sources of financing to the economy.

The debate continues. The European Council of Ministers has yet to reach a common position on the proposal and only then can it move into the final "trilogue" stage, when all three institutions will put their heads together and agree on the final text of the Regulation.

Are bond funds a systemic risk?

Bond funds are also coming under the policymaking spotlight. Officials from EU institutions, national treasuries and central banks are seeking closer oversight of bond funds amid concerns about shadow banking. They voiced their concerns in a letter, presented to finance ministers in April. "A more focused monitoring of increasing activity in non-money market funds is needed, as well as of any existing inter-linkages with traditional banking groups," according to the letter.

The letter's contents add to remarks from global regulators, including the FSB, that investment funds are increasing allocations to long-term debt, in particular debt originated in emerging markets, which has higher yields. FSB Chairman Mark Carney warned in early 2015 about the risk of a "sharp and disorderly reversal" in markets if investors offload their holdings at the same time. A loss of liquidity in the market could produce a shock to the banking system.

Market stability is on local regulatory agendas, too

National regulators have, in some cases, moved faster than the global consensus in trying to address the risk of market instability.

In **Brazil**, as the fund industry has increased its exposure to credit risk from the real economy, the Comissão de Valores Mobiliários (CVM) has issued guidance that it expects fund managers and administrators to follow when purchasing loans or investing in non-sovereign fixed income securities.

In **Mexico**, the Central Bank of México (Banxico) presented, in late 2014, analysis it had been developing on Systemic Risk and the SIFI for "anonymous" groups, but has not yet issued regulation or published specific requirements.

Meanwhile, in **Greece**, a new law (Article 66) demands that institutions prepare emergency liquidity plans in case of significant economic deterioration. More generally, ongoing concerns about the stability of the Eurozone has led regulators and the industry to think through the impacts on funds of a country's withdrawal from the currency bloc.

Also, in addition to bedding down the new requirements of the European OTC derivatives regulation, EMIR, **European** investment managers are heavily engaged with the debate on the recovery and resolution process for market infrastructure providers. The nub of the issue is whether it is appropriate for clients' monies to be used in the winding-up of a Central Clearing Party (CCP).

Orderly markets and good conduct remain a priority

The greater volume of conduct measures are predominantly targeting the retail market under the objective of investor protection, but it is important for investment firms to be aware that the wholesale channel is also within scope. Firms must consider their whole waterfront of business activities. Telling the regulator they serve only professional clients or operate only in wholesale markets is not a defense against misconduct charges.

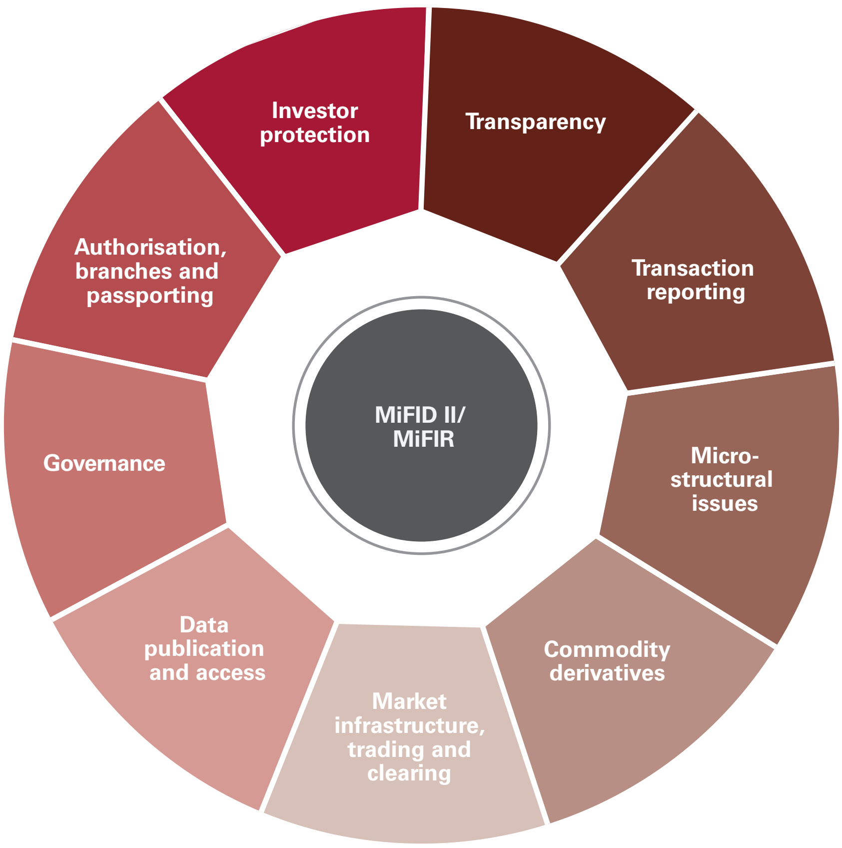
Previous editions of this publication have commented on the breadth of changes in US regulation brought about by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). The many rules emanating from that enormous piece of legislation are still bedding down, and 2015–2017 will see a wave of new regulation being implemented in Europe.

It is fair to say that the revised Markets in Financial Instruments Directive (MiFID II), and its sister regulation MiFIR, is giving **European** investment and fund managers a considerable challenge. The impact of the Directive – which must be enshrined in national laws in 2016 and which comes into effect in January 2017 – impacts nearly every function and department within investment management firms.

In particular, MiFID II introduces fundamental changes to the structure of the wholesale markets that will impact investment managers as users of those markets on behalf of their clients. It includes new rules for "Systematic Internalisers" and for Multi-lateral Trading Facilities, creates a new regime for "Organised Trading Facilities" and introduces a new definition of algorithmic trading. It also introduces compulsory trading and clearing obligations for certain derivatives and rules on non-discriminatory access to clearing and trading venues.

"The many rules emanating from Dodd-Frank are still bedding down, and 2015–2017 will see a wave of new regulation being implemented in Europe."

The many parts of MiFID II/MiFIR



Source: "MiFID II Bites: Best Execution," KPMG International 2015

Components of Best Execution

Source: "MiFID II Bites: Best Execution," KPMG International 2015

One of the key planks of MiFID II is greater transparency in the wholesale markets. It includes revised rules on pre and post-trade reporting and extends a number of the rules for equity markets to the fixed income markets.

The dealing desks of investment managers will have to navigate a new and evolving landscape, in which they must seek to achieve best execution in all their trades for clients. They must review their best execution policies and provide regular and more extensive disclosures to clients as to how that policy has been operated in practice and the resulting decisions on which brokers or trading venues they have used.

Another key piece of EU legislation, which is specifically targeted at conduct in the wholesale markets, is the revised Market Abuse Directive (MAD II). It will apply from 2016 and actually comprises two pieces of legislation – the Market Abuse Regulation (MAR) and the Directive on Criminal Sanctions for Insider Dealing and Market Manipulation (CSMAD). ESMA's[6] proposal for detailed rules underpinning MAR are causing concern for fund managers. In a worst case scenario, if a fund had a "person discharging managerial responsibilities" (PDMR) as a shareholder, the fund could not trade during closed periods in any shares or other issued securities in the company of which that person was the PDMR.

The **UK** has decided to opt out of CSMAD, but the government is introducing "tough new domestic criminal offences for market abuse". In February 2015, the Financial Conduct Authority (FCA) issued the findings of its 2014 review of investment managers' compliance with the current market abuse requirements. It found that, while firms had put in place some practices and procedures to control the risk of market abuse, these were comprehensive only in a small number of firms. In particular, firms need to pay more attention to the possibility of receiving inside information through all aspects of the investment process, to take steps to manage this risk and to improve the effectiveness of post-trade surveillance.

[6] European Securities and Markets Authority

Supervisors taking a more proactive approach

Supervisors of the investment management and funds sector around the globe are increasingly active. This activity is not confined to jurisdictions where rules are changing. Although in many countries the regulation of the sector has been fundamentally unchanged for some years, supervisors are being more intrusive.

For example, in **Bahrain** the regulators are checking how well firms have bedded down rules introduced in 2012. The Financial Services Authority (FSA) in **Hong Kong** is asking more detailed questions about internal processes. And in the **UK**, the FCA is increasingly requiring chief executives formally to attest that their firms are fully compliant with particular rules, in addition to continuing to undertake thematic reviews of the industry. These reviews invariably give rise to statements from the regulator as to what they regard as good and bad practice, and instances of firms being taken through the enforcement process.

Within **Europe**, ESMA has been increasingly active, not only in commenting on the practices of the industry but also with regard to the approaches of the national regulators. A recent ESMA report on industry compliance with the best execution requirements under MiFID I makes sobering reading for some of the national regulators, which had not fully implemented or actively supervised firms against the MiFID I requirements. It is clear that ESMA does not regard this lack of consistency as satisfactory and the document serves to recalibrate regulatory expectations.

ESMA is also flexing its muscles on the technical interpretation of certain rules and the need for national regulators to adopt a consistent approach. For example, despite its enormous workload on the drafting of the very many detailed rules and technical standards falling under MiFID II, it has consulted on eligible share classes for Undertakings for Collective Investment in Transferable Securities (UCITS) – an area on which national regulatory practices have differed widely.

And in some countries, self-regulatory organizations remain active. In **Brazil**, ANBIMA[7] continues to issue codes and guidance on industry good practice. Industry associations without Self-Regulatory Organization (SRO) status are also revising their code and issuing new ones – in Mexico, Italy and the UK, for example.

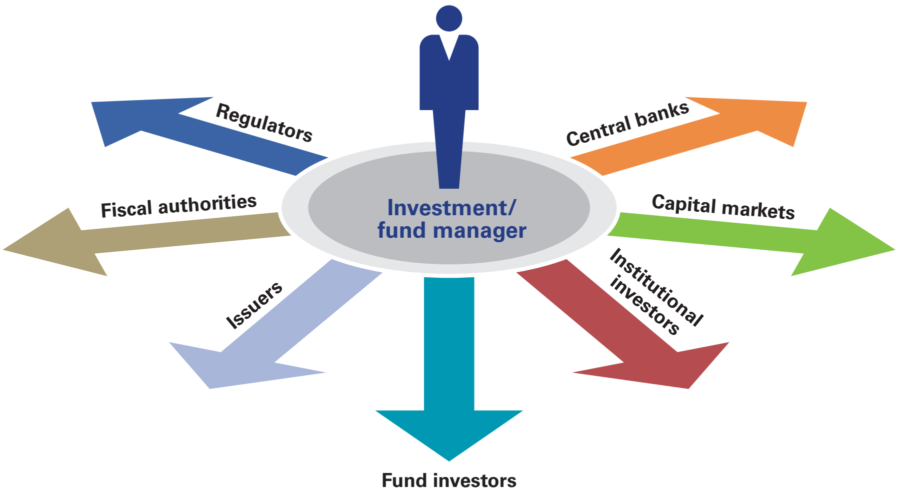
[7] Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais

2. Culture, conduct and conflicts: regulators seektangible change

Key points

- Regulators are intent on improving investment management culture.
- But the focus of different national and regional regulators varies, as does understanding of the words "culture" and "conduct" in a regulatory context.
- Firms are increasingly being required to oversee and actively monitor their counterparties, service providers and distributors.
- They must also focus on internal governance and the security of clients' assets.
- A spotlight is shining on investment management remuneration and value for money.

Regulators are intent on improving investment management culture, associating good culture with better outcomes for consumers. The overriding priority of regulators is that businesses should always put the interests of consumers first. They require strong internal governance, the reduction of conflicts of interest and good conduct in dealings with consumers, intermediaries and market counterparties.



Source: KPMG International, 2015

In part, this agenda is driven by the need to improve consumer trust in the financial services in general. Post the financial crisis, examples of poor behavior in financial markets have continued to hit the headlines.

Investment managers and funds are not immune from this. For example, in the **UK** there has been a protracted media debate about the value of investment management and the fees charged. There have also been accusations that investment funds have "hidden charges". The industry rightly argues that the price of a fund share is net of all costs and charges, but is moving to better disclosure. Nevertheless, the regulator has undertaken a thematic review of fund governance and fund pricing and has required that the industry – both fund managers and distributors – display prominently the "on-going charges figure" rather than the stated annual management charge.

Real cultural change, not box-ticking

The focus of different national and regional regulators varies, as does the meaning of the words "culture" and "conduct" in a regulatory context. This variation arises for a number of reasons – different legal concepts, different constitutional scope and powers of regulators, different histories of regulation and cultural norms, and different approaches to consumer protection.

In their attempts to regulate "culture", there is a risk that regulators focus on ever more detailed rules and that firms ignore the need for genuine cultural change; that is, businesses are encouraged to focus on box ticking rather than undertaking a more fundamental review of their culture and conduct.

Some jurisdictions are starting to encourage fundamental change. In **Dubai**, the emphasis is on education and formal accreditation. Investment management professionals must now sit the Dubai International Financial Centre (DIFC) Rules & Regulations Paper, which was developed in collaboration with the Chartered Institute for Securities and Investment, an offshoot of the London Stock Exchange. The exam provides a benchmark of competence for Dubai's financial industry and enhances the quality of advice and investment.

Recent examples of misconduct spanning both retail and wholesale channels include:

- Libor rigging by a range of institutions.
- Large banks fined unprecedented large amounts for foreign exchange rate-fixing, which impacted both wholesale and retail customers.
- Misconduct penalties on retail banks for failing to promote a capital-protected product appropriately.
- Sophisticated securitization vehicles sold by distributors to ordinary consumers with modest means.
- High risk strategies such as feeder funds based on Madoff and Madoff entities, sold under discretionary management.
- Some continental European banks advised ordinary savers to move out of investments and into bank deposits or bank shares in order to prop up balance sheets, while wealthier clients moved their money abroad.
- Other European banks were non-compliant with MiFID I and sold risky convertible securities (CoCos) to retail customers.
- Some investment firms offered high levels of commission to financial advisers in order to increase sales, with no real monitoring of whether the products were being sold to the right consumers.
- Some investment managers paid for access to investee companies out of client funds.

Key controls within MiFID II Best Execution

Client-facing documents (i.e. terms and conditions) must be appropriately detailed and clear on when it is necessary for Best Execution to be provided per client per instrument.

Governance is crucial in ensuring that the oversight of activities covered by Best Execution rules is of a standard to allow the Board and other senior management to be confident that the organisation is meeting the requirements.

Front office systems and processes must have appropriate controls and be able to provide accurate and granular detail per instrument to your operations and back office teams or you may be put at risk of non-compliance.

Information provided to the Board and other key stakeholders must be of a sufficient quality and detail to allow senior personnel to fully understand how the firm is meeting its Best Execution obligations.

The Compliance and Risk departments will need to enhance their monitoring and ensure it is sufficiently sophisticated and detailed to give appropriate insight and control over activities where Best Execution rules apply.

Best Execution is part of a broader suite of investor protection requirements that are a part of MiFID II (e.g. implementation of related conduct regulation such as conflicts management, client classification and market conduct).

Source: "MiFID II Bites: Best Execution," KPMG International 2015

> "One area of the expected detailed rules underpinning MiFID II that is causing particular concern is the need for European investment managers to review the way in which they pay for investment research.

Good conduct stems from good culture. Firms need to undertake an honest evaluation of their business drivers to stay ahead of the regulatory wave. These include business, environmental, structural, client and behavioral drivers – amounting to an ethical audit.

MiFID II addresses a number of business conduct issues, including (in no particular order):

- the distribution of funds, structured products and securities
- inducements
- disclosure of costs and charges
- internal governance and controls
- product governance
- product complexity (which products can be sold execution-only and which cannot)
- best execution.

Good culture leads to good conduct, improved consumer trust, more business, long-term growth and commercial viability. Importantly, it creates controlled and controllable risks. Good cultural drivers permeate all aspects of the business, challenging old norms, such as "our competitors do it that way" or "our cost structure is built around this model".

So, all potential conflicts should be identified, disclosed, quantified, and eradicated or managed. Every department, function, process, task and piece of information, from top to bottom, should be challenged. Firms need to acknowledge wider responsibilities than just those owed contractually to their immediate clients, thinking always of the end-consumer, however removed they may be.

Firms should also oversee and actively monitor their counterparties, service providers and distributors. This is not about doing the regulator's job, but about managing the firm's own risks and reputation.

In the **US**, this has been evident in the most recent exams and enforcement activities. In addition, the SEC has been active in educating the industry through speeches and guidance. The speeches cover topics including the importance of having a process to identify conflicts of interest – such as hidden fees and expenses, and lopsided reward structures.

In the light of this regulatory agenda, many managers are now evaluating the need to transform compliance through enhanced risk assessment, testing and governance. Under MiFID II, for example, firms will need to identify and disclose conflicts of interest in sufficient detail to enable the client to make an informed decision.

One area of the expected detailed rules underpinning MiFID II that is causing particular concern is the need for **European** investment managers to review the way in which they pay for investment research. Either, they may pay for it themselves; or, if it is to be charged to the client, they must establish a research payment account and a budget, subject to appropriate controls and senior management oversight. Firms providing execution services must identify separate charges for execution and for research. The charge for research must not be dependent on the levels of payment for execution. This will require investment banks to declare the split between execution and research within their brokerage fee, and managers to establish arrangements such as Commission Sharing Agreements.

In **Brazil**, new rules effective from January 2016 clarify the role of the fiduciary administrator and the manager, setting more demanding minimum requirements for policies and procedures and obliging firms and individuals to supply more detailed information to the regulator. Also, firms must publish a code of ethics.

Conduct measures focus on consumer protection

A number of regional and global efforts are driving conduct measures. They may have different approaches and focuses, but the direction of travel is clear: poor conduct in any area of investment management will be investigated and punished.

The G20 and OECD are leading the way at a global level. The Task Force on Financial Consumer Protection[8], endorsed by the G20 in 2012, has more recently developed a second set of Effective Approaches, dealing with six of the 10 High-Level Principles on Financial Consumer Protection:

- Legal, Regulatory and Supervisory Framework
- Role of Oversight Bodies
- Equitable and Fair Treatment of Consumers
- Disclosure and Transparency
- Financial Education and Awareness
- Responsible Business Conduct of Financial Services Providers and Authorized Agents
- Protection of Consumer Assets against Fraud and Misuse
- Protection of Consumer Data and Privacy
- Complaints Handling and Redress
- Competition.

In terms of implementation and supervision, regulators are likely to talk more and collaborate more, leading to a convergence of regulatory focus and collaborative application of penalties for conduct failures.

[8] http://www.oecd.org/daf/fin/financial-education/G20-OECD-Financial-Consumer-Protection-Principles-Implementation-2014.pdf

> “...fiduciary obligations are likely to be placed on asset managers and pension plans. Strict liability could be imposed on the pensions industry, with the SEC insisting that entities that exercise control over assets be classed as fiduciaries.

The first review of the European System of Financial Supervision, which includes a report on the progress of the European Supervisory Authorities (ESAs), took place in 2014. The ESAs – the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the ESMA – were advised by the European Commission to allocate “a higher profile to consumer and investor protection, and the focus on aspects of the financial supervisory union should be strengthened”.

ESMA is at the forefront of discussions aimed at ironing out differences in rule interpretation within the fund management sector. All national regulators are expected to operate consistently and at the same level of supervisory and enforcement activity.

Germany, for one, has reacted to losses suffered by many retail investors who participated in unregulated capital investments in the so-called “grey capital market”. The German summer government announced a package of legal rules in 2014 designed to improve investor protection and the transparency of offerings on the unregulated capital market.

This resulted in the Retail Investor Protection Act (*Kleinanlegerschutzgesetz*), which was passed by Parliament in April 2015 and is expected to come into force on 1 July 2015. The Act gives the German Federal Financial Supervisory Agency (BaFin) powers to publish violations of the Capital Investment Act on its website to warn investors. BaFin can order the financial reports of an issuer of a capital investment to be reviewed by an external auditor if there are indications of a potential violation. The maximum administrative fine for violating disclosure obligations is EUR 250,000.

The Act also contains two important new provisions that anticipate MiFID II requirements: 1) the new empowerment for BaFin to restrict or prohibit the sale of financial products will be available from 1 July 2015, and 2) the related MiFID II product intervention rights become effective only after January 3, 2017.

The Central Bank of Ireland took a different approach when it consulted in September 2014 on fund management company oversight of delegates. **Irish** fund managers will have to adhere to guidance, rather than rules, on what constitutes good practice and there is to be a streamlining of a fund's managerial responsibilities.

In **Canada**, regulators continue to create regulation under the investment fund modernization project and Client Relationship Management (CRM) 2 project, aiming to ensure clients receive comprehensive and transparent information on the cost and performance of their investments. In particular, the regulator is focusing on:

- simplified and fact-based reporting
- the cost of investment products
- enhanced disclosure to investors of costs of their investments and investment advice
- mutual fund fees
- trailer and other fees.

In the **US**, consumer protection is being extended to pension beneficiaries under an amendment to the “529 Act[9]”. Under the Act, fiduciary obligations are likely to be placed on asset managers and pension plans. Strict liability could be imposed on the pensions industry, with the SEC insisting that entities that exercise control over assets be classed as fiduciaries. This implies a far greater information exchange between fund managers and pension plans than currently exists, in order to comply. The initiative is being driven by the US Department of Labor (DOL), which wants more transparency in the pensions industry, particularly over fees and costs. A number of recent abuses have convinced the DOL that the industry is not adequately protecting the end-consumer, the pension fund beneficiaries.

[9] Chapter 529 of the Company Service Providers Act

A spotlight on investment management remuneration

The link between pay and conduct is firmly established in the minds of regulators, nowhere more so than in **Europe**.

MiFID II focuses on conflicts of interest associated with sales practices. From January 2017, all investment firms need to ensure that staff remuneration incentives do not encourage inappropriate sales practices. The question of whether sales remuneration rules should be applied to firms not under MiFID II is also under consideration. The rules relating to shares, bonds and structured deposits will be elaborated at the end of the consultation period too. The final rules will be confirmed by July 2016.

The requirements on remuneration in the Alternative Investment Fund Managers Directive (AIFMD) focus on financial stability and risk management. Alternative Investment Funds (AIFs) should have remuneration policies and practices that promote sound and effective risk management and do not encourage risk-taking that is inconsistent with the risk profiles, rules or instruments of incorporation of the AIFs they manage.

AIFMD requires that the fixed and variable components of remuneration should be appropriately balanced to avoid excessive risk-taking. In other words, the fixed proportion of total remuneration must represent a high proportion of the total remuneration paid.

AIFMD does not, however, provide for a cap on variable remuneration. But at least 50 percent of variable remuneration should consist of units or shares of the AIF and at least 40 percent should be deferred over an appropriate period reflecting the lifecycle and redemption policy of the AIF.

As with the AIFMD, UCITS management companies are required to establish and maintain remuneration policies and practices that are consistent with sound and effective risk management and that do not encourage risk-taking inconsistent with the risk profiles, rules or instruments of incorporation of the UCITS they manage. Under UCITS V[10], fixed and variable remuneration should also be appropriately balanced. Early drafts of UCITS V included a 1:1 bonus cap and prescriptive measures on the charging of performance fees. Although, these provisions were later deleted, it is possible they could be revived at a later stage.

The fourth Capital Requirements Directive (CRD IV), meanwhile, provides for a basic ratio of fixed and variable elements of 1:1, which can be increased to 1:2 with shareholder approval. Also, a discount rate can be applied to 25 percent of variable remuneration provided it is paid in long-term deferred instruments. In addition, 100 percent of bonus payments may be clawed back if an individual is culpable in future financial losses.

Manager remuneration is becoming an issue in emerging markets too. In **Brazil**, Bacen, the banking regulator, has already imposed minimum limits for the proportion of variable remuneration that must be paid in shares and the proportion that must be deferred, although these apply only to the C-suite.

[10] Directive amending Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) as regards depositary functions, remuneration policies and sanctions

New focus on product governance

In a number of EU Member States, MiFID II brings in for the first time detailed product governance requirements for firms that manufacture or distribute funds or structured products. The requirements are also relevant for investment firms offering or recommending products manufactured by firms not captured under MiFID II.

In particular, manufacturers must ensure that products meet the needs of an identified target market of end-clients, that their distribution strategy is compatible with that target market, that they take reasonable steps to ensure that the products are distributed to the target market, and that they periodically review the identification of the target market and the performance of the product. The product governance requirements are wide-ranging and cover all aspects of the product design, change and monitoring process. This includes effective controls, stress testing, analysis of potential conflicts of interest, consideration of potential impact to the orderly function of the market, identification of the target market, appropriately aligned distribution strategy, appropriate product information, appropriately trained staff, and so on.

Investment firms that distribute products other than their own must have appropriate arrangements to obtain and understand relevant information on the product approval process, including the identified target market and the characteristics of the product. This requirement is in addition to the appropriateness and suitability requirements with which the firm must comply. For financial instruments issued by non-MiFID firms, distributors must have appropriate arrangements to obtain sufficient information about the instrument.

ESMA's advice to the Commission on MiFID II rules took into consideration three existing policy documents: "Manufacturers' Product Oversight and Governance Processes", issued in November 2013 by the three ESAs; "Regulation of Retail Structured Products", issued in December 2013 by IOSCO; and ESMA's opinion of March 2014 on "Structured Retail Products – good practices for product governance arrangements". Although these were issued a year or so ago, many firms may not have reviewed their product governance and processes against these policy statements, in part because national regulators have not all actively engaged with firms about their product processes. MiFID II will force firms to undertake a thorough review and will require the national regulators actively to supervise firms in this regard.

ESMA's advice acknowledges that many products can be considered compatible with the mass retail market. Therefore, the target market may be very wide and generally described. However, ESMA goes on to say that "for more complicated, less mainstream products, such as convertible securities or structured products with complicated return profiles, the target market should be identified in more detail".

All UCITS and AIF managers, even if not directly subject to MiFID, will also have to review their product governance processes because the distributors will be required to seek information from the managers.

It is now for the Commission to decide the shape of the final Level 2 measures, expected during 2015. Firms must be in full compliance by January 2017.

Costs and charges under review

Regulators, particularly in **Europe**, are asking why costs have not fallen as a proportion of assets managed, despite large rises in assets under management in recent years.

Under both MiFID II and the Regulation introducing a Key Information Document for Packaged Retail Investment and Insurance-based Products (the PRIIP KID), fund managers will be expected to disclose more detailed information relating to underlying costs and charges in the fund, over and above the requirements of the existing UCITS Key Investor Information Document (KIID). However, financial advisers say that while the industry should be applauded for improving transparency around costs and charges, the level of detail being called for is unnecessary. There is a risk of "information overload" with too many figures being provided to investors, they argue.

The issue of costs and charges has brought into focus the added value created by investment managers. **Luxembourg** and **Sweden**, for instance are casting a critical eye over active funds that are, in fact, closet index trackers but charge higher fees. In March 2015, the Swedish government began an investigation into such funds.

Meanwhile, the Danish regulator, Finanstilsynet, launched an investigation into the phenomenon in September 2014 and found that almost a third of the 188 domestic equity funds in **Denmark** could be classified as closet trackers. ESMA subsequently decided in early 2015 to gather more information on the issue before deciding whether to take action.

Similar preoccupations can be found in a number of jurisdictions where pension fund charges are under the microscope. Some policymakers are questioning the level of fees paid to investment managers and are seeking greater disclosures.

> "Fund managers will be expected to disclose more detailed information relating to underlying costs and charges in the fund.

> "Under UCITS V, fund managers will have to evidence strong governance and operational separation between the depositary and the manager if they are in the same financial group.

Good news, bad news for private funds

In the US, the SEC is focusing on custody for special purpose vehicles (SPV) used by private pooled investments, such as hedge funds and private equity funds. The Custody Rule, implemented in 2010, has been updated. It requires registered investment advisers to guard against the misuse or misappropriation of clients' funds. Private funds have found it challenging to comply but new guidance issued in 2014 brings some relief. A private fund is exempt if, among other things:

- The fund is subject to audit at least annually by an independent public accountant.
- Audited financial statements are distributed to the fund's beneficial owners within 120 days of the end of the fiscal year.

However, it's not all good news for private fund vehicles: the new guidance may result in more audits or surprise examinations by the SEC.

Onus on looking after clients' assets

European regulators have gone to great lengths to make sure asset management clients do not suffer losses as a result of fraudulent or careless behavior.

EMIR, which tackles segregation and, re-hypothecation of assets, is a leading example of this preoccupation. Broadly, under EMIR, clearing brokers must offer individual segregated accounts in which individual client assets are isolated, or omnibus segregated accounts in which client assets can be commingled with those of other clients.

Under the incoming Central Securities Depositary Regulation (CSDR), a new settlement discipline regime will come into force whereby failed trades will face a mandatory buy-in, and CSDs would have to buy back an asset at the prevailing market price and deliver it to the non-defaulting counterparty. Following consultations with market participants, there has been criticism of this rule, with CSDs arguing the buy-in process should take place at the trading level, not the settlement level. It is now up to ESMA to referee the disagreement.

Meanwhile, MiFID II removes title transfer collateral arrangements for retail clients and regulates custody arrangements.

Under UCITS V, which will come into force in 2016, depositaries will be responsible for replacing lost assets, even in the event of fraud or failure of a sub-custodian. Much of the European fund management industry will undergo a "culture change" next year as depositaries become more "intrusive" under the new UCITS V rules. The due diligence procedures carried out by UCITS depositaries will be similar to those under the AIFMD, which have proved onerous.

ESMA has now finalized its advice to the Commission on two aspects of the UCITS V depositary provisions that are additional to AIFMD: the necessary steps to ensure that in the event of insolvency of a third party, UCITS assets are ring-fenced; and the conditions for fulfilling the requirement that the management company and depositary must act independently.

Fund managers will have to evidence strong governance and operational separation between the depositary and the manager if they are in the same financial group. In the **UK**, UCITS managers and depositaries have traditionally been in different groups, even where the manager is owned by a bank. On the Continent, however, where bank-owned fund managers form the majority, the new requirements could require a fundamental review of the manager-depositary relationship.

Jurisdictions that have become financial centers for international domiciliation and distribution of investment vehicles, such as Luxembourg and Ireland, are pushing ahead with fund and client asset rules in order to enhance their credibility and brands.

Luxembourg has effectively "jumped the gun" on the UCITS V requirements. In July 2014, the Luxembourg regulator, Commission de Surveillance du Secteur Financier (the CSSF), forged ahead with measures to reinforce investor protection and strengthen investor trust in domestic UCITS funds by issuing new rules for depositaries that give them a significant oversight role on fund operations and the monitoring of cash flows. There must be proper segregation of UCITS assets and protection from insolvency of the delegate. Depositaries need to ensure that their due diligence process for the selection and ongoing monitoring of depositary delegates meets the new regulatory standards and that processes are in place properly to identify and manage conflicts of interest.

In **Ireland**, on 30 March 2015 the Central Bank of Ireland published the Investor Money Regulations and the Client Asset Regulations. The former will apply to fund service providers for the first time; the latter update the current regime, tightening governance arrangements around client assets. Firms are required to appoint a Head of Client Asset Oversight, which will be a pre-approved controlled function. The appointee will need to be approved by the Central Bank. Firms are required to create, document and maintain a Client Asset Management Plan. There is an obligation for firms to give clients a Client Asset Key Information Document, which sets out how their assets will be managed. Similar governance arrangements feature in the Investor Money Regulations.

3.

Policymakers incentivize private investment

Key points

- Many countries, particularly in the West, are encouraging more private investment to fill the gap in bank funding of fledgling enterprises, and public funding of physical and social infrastructure.
- New securities markets are opening up and new financing structures and fund products are being introduced.
- The investment management sector is being urged by many governments and policy makers to facilitate private investment in a wider range of markets and asset types.
- But many regulators remain cautious about the extent to which ordinary citizens with modest savings should invest in such asset classes.
- Responsible stewardship of equity investments in listed companies remains on the agenda.

One of the major impacts of the financial crisis was to create funding gaps for governments. Many countries, particularly in the West, are still grappling with sizeable debts and budget deficits that create obstacles to public investment and economic growth. Their answer, increasingly, is to encourage more private investment.

The need for more private investment to fund fledgling enterprises and physical and social infrastructure is exacerbated by the regulatory demands on banks to strengthen their balance sheets, which has led many significantly to reduce their lending activity.

Meanwhile, many emerging countries are seeking to boost inward investment and to encourage individual wealth to be invested domestically, in order to strengthen their internal capital markets and economies.

The result is the recent opening-up of new securities markets and financing structures and a green light by policymakers to introduce new fund products.

This should be good news for the investment management sector, which is being urged by governments and policymakers to facilitate the flow of investors' monies into an ever-widening range of markets and asset types. However, regulators have expressed concerns about the extent to which ordinary citizens with modest savings should be invested in such asset classes.

Also, not all countries are encouraging investment even in highly liquid securities, with some actively warning their citizens of the riskiness of any forms of investment over savings in bank deposits. Although more countries are introducing forms of tax-incentivized savings accounts, the majority of the savings in these accounts remains in cash.

> "Restrictions in China on foreign investors and investment managers have been relaxed through the QFII quota system and, more recently, through the RFQII quota.

The flowering of securities markets

One of the biggest opportunities created through positive regulation can be found in mainland **China**, where the government is gradually opening its borders and allowing the internationalization of the Chinese currency.

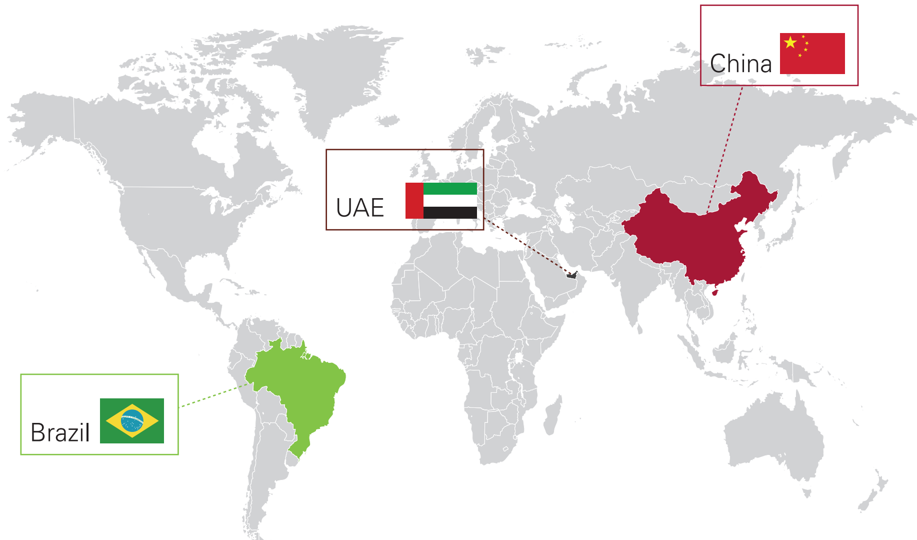
Restrictions in China on foreign investors and investment managers have been relaxed through the Qualified Foreign Institutional Investor (QFII) quota system and, more recently, through the Renminbi Qualified Foreign Institutional Investor (RQFII) quota. RFQII represents a step forward for foreign fund managers because it relaxes restrictions on the repatriation of funds by Chinese ex-pats and allows for daily dealing. It also allows quotas to be allocated across funds, rather than used for a single fund. This enlarges the opportunity set.

Already European and US investment firms are using the RQFII regime to launch UCITS funds invested in China, which are sold across Europe and more widely.

Although the RFQII system was loudly welcomed outside China, it is interesting that take-up of the country allocated quotas has generally been slower than expected. In part, this may be explained by lagging investor sentiment towards China, but the new opportunities provided by the Shanghai-Hong Kong Stock Connect, at potentially lower cost, may be a contributory factor.

Stock Connect pushes HK volumes to record high

After a slow start in the first few months with an average usage of 40 percent of the daily quota, the daily quota under the Southbound trading link was fully utilized on consecutive days in April 2015 after the mainland authorities gave domestic mutual funds permission to use the scheme in March. This pushes total market turnover in Hong Kong to a record high of HKD 252.4 billion, surpassing the 2007 level, and market capitalization to HKD 28.6 trillion, making Hong Kong the highest market capitalization exchange in the world. As of April 2015, about 23 percent of the aggregate quota of RMB 250 billion for southbound investors and 39 percent of the RMB 300 billion limit for the northbound link had been utilized.



Source: KPMG International 2015

Shanghai-Hong Kong Stock Connect boosts the markets

Shanghai-Hong Kong Stock Connect only took seven months to launch after its initial announcement in April 2014. It provides investment managers in both **Hong Kong** and **China** more room for creativity in product development, opportunities for arbitrage trading and flexibility in product development. The success of the program also improves the confidence of markets in the new Shenzhen-Hong Kong Stock Connect.

According to the Hong Kong Stock Exchange (HKSE) and Shenzhen Stock Exchange (SZSE), the long-awaited Shenzhen-Hong Kong Stock Connect may be opened in the second half of 2015. It was already announced that shares on the ChiNext board were likely to be included in the trading link with the Hong Kong board. Other financial instrument types, including fixed income and futures products, may also be brought into trading of Shenzhen-Hong Kong Stock Connect first in future.

The longer-term impact of Stock Connect may be that quotas, such as the RQFII quota, may cease to be as prized as they are today. Over time, quotas may be redundant or, at least, usage may be cheaper, because a cheaper alternative exists in Stock Connect.

Middle Eastern and Latin American markets open up, too

In some countries, policymakers are going one step further than expanding their markets, by launching whole new investment centers. A prime example is the **United Arab Emirates** (UAE), which is in the process of setting up the Abu Dhabi Global Market (ADGM). Announced in 2014, the center is aiming to build on the success of Dubai. It is also partly in response to the opening-up of Saudi Arabia's largest stock market to foreign investors in June 2015.

To attract foreign institutions and investors, Abu Dhabi's government has said that ADGM will be governed by a recently-created independent regulator, the Financial Services Regulations Bureau, and that rules and regulations will be aligned with international best practice standards recognized in other international financial centers.

The backdrop to the UAE move is the desire to emulate Saudi Arabia and be accepted within the G20, which requires an increase of accessibility to the country's capital markets.

Qatar has already made moves in this direction, including the opening of the Qatar Financial Centre as long ago as 2005. Some observers expect **Iran**'s markets to start to open in the next few years.

The likely expansion of Middle Eastern markets will not, of course, take place because the regulators wish it. The region has natural advantages, such as being ideally positioned to serve the growing wealth in Asia and Africa. It can also tap the "iceberg wealth" of Middle Eastern investors. Currently, domestic investments are only a very small part of individuals' portfolios. This could change as volumes surge and confidence rises in Middle East asset markets.

Other emerging markets are opening up, too. **Brazil** has relaxed rules for local funds that invest internationally in a move that could open up new opportunities for UCITS managers.

Under new rules, Brazilian funds offered to retail investors will be able to invest up to one-fifth of their assets overseas, up from 10 percent. Qualified investors, with BRL1 million (EUR 289,000) of investable assets, will be able to invest in funds that may allocate up to 40 percent of their portfolios in foreign assets. Professional investors, with a minimum BRL10 million of investable assets, will for the first time have access to funds entirely invested in foreign assets.

Brazil's regulator, the CVM, has removed rules requiring qualified investors to make a high minimum investment in a single fund. While UCITS are not specifically mentioned in regulation, the rule change means more people will be able to access these European vehicles, which are already widely used in parts of South America.

Facilitating greater investment flows in already open markets

Both within the EU and among the ranks of the G20, the agenda is increasingly focusing on growth.

Japan has been seeking to promote investment in emerging and growing companies. It has introduced a new trading system for unlisted shares and has reduced the administrative burden for newly-listed companies, which can now choose whether to not to have their internal control report audited by a Certified Public Accountant.

In **Europe**, in particular, the slow recovery from recession and the weak growth rate has led policymakers to look at ways of releasing capital from private hands on a regional basis. "Capital Markets Union" (CMU) is the over-arching banner within Europe, with momentum growing behind building capital and securities markets. Market solutions such as private placement and securitization are widely seen as alternatives to bank financing. The current heavy reliance within the EU on bank financing is in stark contrast to the US market and has been cited by many commentators as the key to slower economic recovery within the EU.

The EU President's mission letter in September 2014 to Financial Services Commissioner-elect Hill talked about "sustainable and high quality securitization markets" which could "develop alternatives to our companies' dependence on bank funding" and bring about a Capital Markets Union, encompassing all Member States, by 2019.

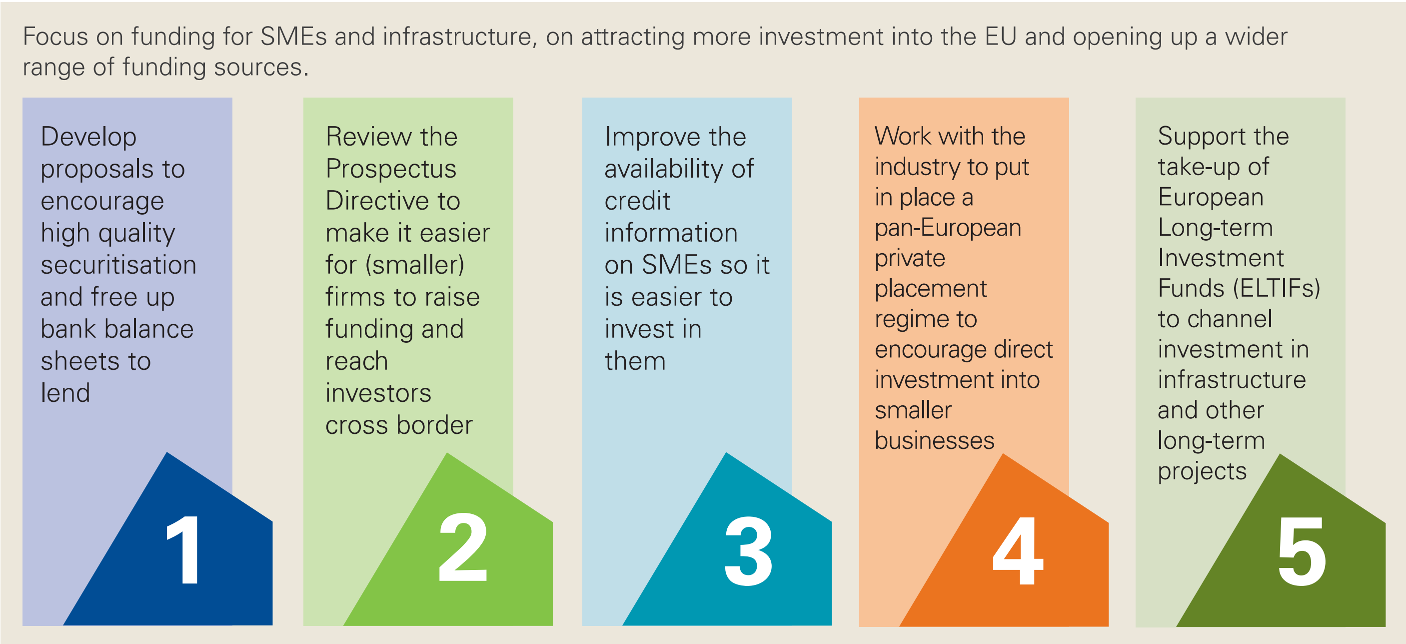
The Commissioner-elect's hearing in front of MEPs in October 2014, signaled his willingness to accept the mission. He expressed his desire to "enable the free flow of capital within the EU and globally and include a single market for European financial instruments".

"In Europe, in particular, the slow recovery from recession and the weak growth rate has led policymakers to look at ways of releasing capital from private hands on a regional basis.

These high level comments were followed by a Commission Green Paper, published in February 2015, which focused on funding for SMEs and infrastructure, on attracting more investment into the EU and on opening up a wider range of funding sources.

Commissioner Hill has since stated that in 2015 the Commission will bring forward one-fifth of the number of new legislative proposals that the last Commission proposed each year: "We are working to legislate less and do fewer things better", he said. Commissioner Hill has also acknowledged that while the speed at which legislation developed after the financial crisis was necessary to make the financial system stronger, it should now be revisited. "Not to question the fundamentals of the approach, but to take a look at the combined effect of our legislation and ask ourselves whether we have always achieved the correct balance between stability and growth".

European Commission Green Paper, 18 February 2015



Source: KPMG International 2015

Stimulating investment in alternative assets

Three new EU fund regimes – EuSEFs, EUVECAs and ELTIFs – have been adopted as early steps under CMU.

In March 2015, the **European Long-Term Investment Funds** (ELTIFs) Regulation was adopted. ELTIFs are EU AIF with EU Managers authorized under the AIFMD. Access by retail investors is restricted to those with investible portfolios of at least EUR 100,000 and they can invest no more than 10 percent of their portfolio in ELTIFs.

The range of eligible assets is wide. As well as unlisted small or medium enterprises (SMEs) and infrastructure projects, ELTIFs can invest in real estate (only long-term projects where the investments are "smart, sustainable and long-term"), intellectual property (such as patents) and listed SMEs with a market capitalization of no more than EUR 500 million. The use of derivatives and borrowing is restricted. An initial proposal that an ELTIF must have a minimum percentage invested within the EU was dropped.

The regime is optional, but under the banner of CMU the Commission is urging regulators to implement the Regulation and the industry to launch funds. However, investor appetite has been low. Larger institutions can already invest in such assets direct or via AIFs and do not necessarily wish to invest in funds with constrained investment and borrowing powers. On the other hand, the range of "retail" investors who can access these ELTIFs is very limited. The Commission is seeking feedback on how the regime could be improved, but resistance from ESMA and the national regulators to allow a wider range of retail investors to invest in ELTIFs remains strong.

The **European Venture Capital Fund** (EuVECA) Regulation is targeted squarely at SMEs. It covers funds that are at least 70 percent-invested in unlisted companies with a balance sheet of no more than EUR 43 million or annual turnover of no more than EUR 50 million.

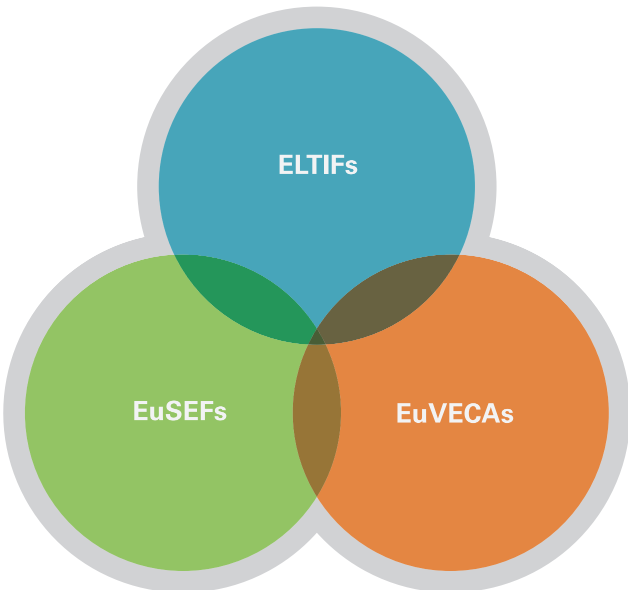
Its sister, **European Social Entrepreneurship Funds** (EuSEF) Regulation covers funds that are at least 70 percent-invested in companies that have the primary objective to have measurable, positive social impacts: that is, they provide services or goods to vulnerable, marginalized, disadvantaged or excluded persons.

The European authorities are determined that these flagship proposals should not suffer from any adverse publicity resulting from flaws in their design. In its Technical Advice to the Commission on the EuSEF and EuVECA Regulations, in February 2015, ESMA provided guidance on how fund managers should identify conflicts of interest and the procedure to be followed to prevent, manage, monitor and disclose them. It also detailed the procedures required in order to measure the social impact of each fund. The results of assessments must be disclosed to investors in a clear and transparent manner. Also, the ESMA advice enhances the process to disclose information to investors prior to taking an investment decision. In particular, the EuSEF manager should provide information regarding the types of qualifying portfolio assets.

Countries are introducing new local funds

New vehicles are springing up as a result of local policies within Europe. Since October 2014, Qualifying Investor Alternative Investment Funds (QIAIFs) in **Ireland** have been permitted to engage in direct lending to corporate entities, with the first loan-originating QIAIF being authorized on 3 March 2015[11]. These loan funds are subject to the AIFMD and can use its marketing passport.

Regulated EU alternative investment funds



Source: KPMG International 2015

[11] The Connect-Ireland Diaspora Loan Fund plc

Similarly, in **Germany**, BaFin has said that it will permit certain German investment funds to originate, restructure and extend loans. BaFin has resisted such a move in the past, but now acknowledges that that the AIFMD does not impose any restrictions on an AIF and that the EuSEF, EuVECA and ELTIF Regulations all consider loans granted to certain portfolio companies as eligible investments.

In **Brazil**, Instruction 555 comes into force in 2015. It includes new definitions of professional and qualified investors and allows new investment limits in fund portfolios to be less restrictive for funds invested in only by such investors.

Not all national regulators are encouraging market investment, though. In May 2015, **Spain's** central bank issued a warning of the risks that local retail investors assume when putting their savings into investment funds. In its latest Financial Stability Report, the Banco de España warns that "the risk assumed by investment fund unit-holders is higher than that assumed by customers who place their savings in bank deposits".

More efficient cross-border vehicles

In a complicated investment landscape, in which the costs of managing funds across borders are increasing due to regulation, tax and increasing complexity of strategies, some jurisdictions are launching vehicles that aim to reduce administration costs.

The **Irish** Collective Asset-management Vehicle (ICAV), for example, came into effect in March 2015 and provides managers with a corporate structure that is designed specifically for investment funds and that is not subject to company law. This helps to reduce the administrative burden and cost. The new structure provides a number of benefits:

- a tailor-made corporate structure which excludes elements of company law not appropriate to an investment fund
- a regulated corporate fund structure which is more tax efficient for US investors
- can be established either as a UCITS fund or an alternative investment fund (AIF)
- existing funds will be able to convert or re-domicile to the ICAV
- acts as an alternative to similar vehicles available elsewhere.

Meanwhile, the **UK** market is seeing the launch of the first "Authorised Contractual Schemes", the regulation of which was introduced in 2014.

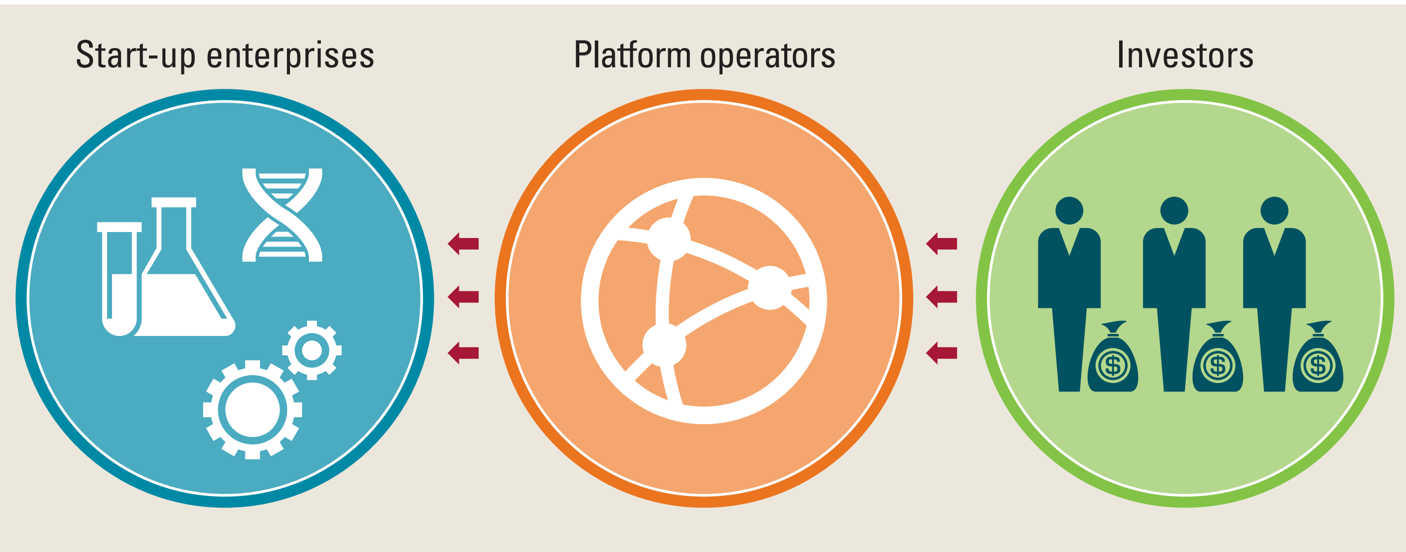
Growth of crowdfunding attracts rule-makers' scrutiny

A revolution taking place in the financing of small companies is being supported by many countries. But its very success and rapid expansion is starting to attract more critical regulatory focus.

In Europe alone, the market for online alternative finance grew 144 percent in 2014 to almost EUR 3 billion[12] and is forecast to reach EUR 7 billion this year as countries support crowdfunding efforts and growing numbers of corporates seek new sources of capital.

In the **UK**, the European hub for crowdfunding, the government is keen to foster the nascent investment vehicles. It has pledged to consult on whether to include equity and loan

Promoting the use of equity crowdfunding



Source: KPMG International 2015

[12] Financial Times, 23 February 2015

crowdfunding within tax-efficient individual savings accounts (ISAs) as part of attempts to bring alternative finance into the mainstream. This follows a promise to add peer-to-peer loans to the ISA regime, which is expected to take effect in early 2016.

At the same time, the UK FCA is starting to intervene in the marketing of equity crowdfunding, peer-to-peer lending and mini-bonds, after it found a series of problems in how providers communicate what they offer. The regulator investigated and found that providers emphasized the benefits and not always the risks of crowdfunding, publishing insufficient, partial or cherry-picked information[13].

In the **US**, the *Jobs Act*, is supporting crowdfunding. The new law is helping to simplify rules that govern US capital-raisings and securities sales and will allow equity and debt raising to take place via crowdfunding. The act allows platforms such as Kickstarter to move away from the model of exchanging money for small gifts and to allow people to take equity stakes in the projects they are funding.

Meanwhile, in **Japan**, crowdfunding is seen as another way to revitalize growth. However, the Financial Services Agency of Japan is also worried about the risks. It recently set out legislation to prevent fraudulent behavior, insisting that crowdfunding platform operators must conduct checks on the businesses of the start-ups and provide information about issuers appropriately online[14].

Responsible stewardship remains in regulators' sights

Regulators have not been distracted entirely from the more traditional debates about shareholder engagement in listed companies. There is renewed scrutiny by some regulators of the extent to which investment managers

play an active role in encouraging good governance and business strategies in companies in which they have invested their clients' monies.

In **Japan**, the Corporate Governance Code was published in March 2015, following on from the Stewardship Code that was published in February 2014. The latter set out principles for responsible institutional investment with the aim of promoting sustainable growth of companies through investment and dialogue. Institutional investors are expected publicly to disclose on their website their intention to accept the Code and annually to review and update the disclosed information. The Corporate Governance Code seeks to achieve sustainable corporate growth and increased corporate value over the mid to long-term. It entered into force on 1 June 2015 along with the new Securities Listing Regulations.

Meanwhile, in **Europe** the Commission has issued a proposal to revise the Shareholder Rights Directive. The existing directive aimed to facilitate cross-border voting by removing identified barriers such as share blocking, timely access to relevant information, and the complexity of voting, in particular, proxy voting.

The revised directive introduces new obligations for institutional investors and investment managers. They must publicly disclose their engagement policy and actual activity, focus on long-term company performance and undertake oversight of related party transactions. The proposal also requires greater transparency of proxy voting advisers and, where an institution appoints an investment manager, details of that arrangement must be publicly disclosed. The last point in particular is the cause of heated debate among officials and the industry.

[13] Financial Times, 6 February 2015
[14] Financial Services Agency, Japan – 2014 Amendment of Financial Instruments and Exchange Act (Act No.44 of 2014)

4. **Governments incentivize** long-term savings

Key points

- The need for increased retirement savings remains at the forefront of policymakers' minds.
- There is a raft of changes to existing pension regulation and the introduction of new pensions products and tax-free savings accounts.
- The investment and fund management industry will benefit from more assets to manage and opportunities to launch new fund-based retirement products.
- It contrasts with the debate about investment management and systemic risk, in which large increases in assets under management are causing policy-makers concern.

Worldwide, retirement savings remains at the forefront of policymakers' minds as the steady shift from government-provided retirement income to personal provision continues.

The result is a raft of changes to existing pension regulation and the introduction of new pension products and long-term savings accounts.

This is good news for the investment management and fund management industry, which will benefit from more assets to manage and opportunities to launch new types of fund products to meet the needs of the personal retirement provision market. However, this marks a stark contrast with the debate about investment management and systemic risk, in which large increases in assets under management are causing policymakers to turn the spotlight onto the industry.

Second pillar pensions for more citizens

Many governments are focusing on pension arrangements for their citizens, well aware that pension liabilities could spiral out of control as populations age, putting further pressure on state finances.

Basic state pensions are already widespread, but the introduction of second pillar pensions is encouraging – sometimes compelling – workers to save more for retirement. Some jurisdictions created second pillar pensions years ago and are now revisiting them and overhauling the rules to improve them. Others are only starting on the road to second pillar creation.

Ireland is one of the latter. The Irish government announced at the end of 2014 that its new second pillar public service pension scheme will be called MySaver, and is designed to cover workers with no other pension than state provision.

The scheme is likely to adopt a "soft-mandatory" approach, like the UK system, rather than compulsion, but with scaled savings. Ireland's Society of Actuaries has called for a system for compulsory coverage to be developed for implementation by 2019, saying that auto-enrolment, as a precursor to compulsion, is a waste of resources.

In the **US**, a retirement-savings program was announced by President Obama in 2014 in an effort to help Americans who do not have 401(k) plans. The so-called "myRA" initiative – short for "my retirement account" – is designed to help workers save by allowing them to deduct a percentage of their salary each month to be invested in Treasury securities. The myRA accounts allow people to make initial investments as small as USD 25, which should help lower-income people start saving.

The fact that the plan cannot invest in bonds and shares could prove a deficiency, though. Returns from Treasuries are historically low and few fund managers are likely to be attracted by an initiative that holds out the potential of only very low profit margins. myRA is also taking

"The Irish government announced at the end of 2014 that its new second pillar public service pension scheme will be called MySaver, and is designed to cover workers with no other pension than state provision.

> “In Japan, the Diet is discussing whether eligible investors for DC pension plans should be expanded. Public employers, previously not in scope, are now likely to be included.

some time getting off the ground. In the meantime, a number of US states are picking up the slack, and creating schemes similar to the UK’s government-sponsored National Employment Savings Trust (NEST) workplace pension scheme. NEST is free for employers and is designed to be relatively easy to set up.

A similar situation can be seen in **Canada** where there has been debate about pension reform at both provincial and federal government levels, driven largely by the impact of people living longer and declining savings rates. Some provincial governments have proposed or are implementing government-run provincial pension plans, similar to the existing federally-run Canada Pension Plan (CPP). The federal government is also establishing the concept of Pooled Retirement Savings Plans for employees of companies that do not offer company pension plans.

In **Japan**, meanwhile, the Diet is discussing whether eligible investors for DC pension plans should be expanded. Public employers, previously not in scope, are now likely to be included.

Regulators revamp existing structures

Regulators across the globe are examining costs and value for money in existing pension scheme structures. The catalysts are low fund returns, but also the growth of the investment management industry and the belief among many regulators that pension schemes and their beneficiaries should be able to take advantage of economies of scale. As a result, they are revisiting pension scheme structures and changing them where necessary.

Those countries that are refining and improving their second pillar schemes include **Hong Kong**, whose Mandatory Provident Fund (MPF) System was initially launched in December 2000. At the end of 2013, there were 3.9 million MPF scheme members. The Fund Expense Ratio (FER) has become a focus in recent times with the average FER currently standing at 1.69 percent.

After three months’ public consultation, the Mandatory Provident Fund Schemes Authority (MPFA) announced in March 2015 that a “core fund” will be introduced as the mandatory default arrangements in all MPF schemes to offer a standardized, low-fee, default option to scheme members. The default investment strategy will be designed so that the investment risks will be automatically reduced as a member approaches retirement age. At the same time, the Government and the MPFA will implement a fee control mechanism by limiting the management fees of the core fund to no more than 0.75 percent of assets under management a year. It is expected that legislation will be introduced in the Legislative Council before the end of 2015 and the default investment strategy will be introduced by the end of 2016.

As a substantial portion of the scheme members will choose core funds due to the more favorable fee rates, the ability to implement the default investment strategy will become a core competence of fund managers. Economies of scale will be a major factor and consolidation in the market is anticipated.

Meanwhile, the **Swiss** government has introduced a new law as part of the structural reform of its second pillar pension provision, which requires pension funds to publish all asset management costs in their annual reports. The disclosure has led to scrutiny of some high-cost investments – particularly alternatives – and could lead to more pension funds divesting from the asset class.

In September 2013, the Australian Securities and Investments Commission (ASIC) published a consultation on the cost of self-managed super funds, in which investors manage their own pension funds and the underlying investments. These represent about 35 percent of the total pension sector in **Australia**. It was found that, compared with the larger super funds that have many members, the annual administrative costs are much higher, especially if the balance in the fund is less than AUD 100,000. ASIC is currently keeping a close eye to see whether costs can be brought down.

Costs are also being addressed by MySuper, which was launched in Australia in early 2014. The intention of the MySuper legislation is for market participants to create a range of easily comparable, relatively simple products, which in turn will focus competition on net costs and returns. The Australian Prudential Regulation Authority (APRA) will further foster competition by publishing fee tables.

EU-wide pensions initiatives

Creating pensions standards and structures that cross national boundaries is no easy matter. But if they can be conceived and implemented successfully, the benefits for pension scheme members in terms of flexibility, choice and cost savings could be substantial.

This is exactly what the Commission set out to achieve through its 2003 Institutions for Occupational Retirement Provision Directive (the IORPD).

However, despite the IORPD, there are still very few cross-border pension funds in **Europe** – less than 100, compared to around domestic 140,000 IORPs in the EU as a whole. The Commission's aim is now to bring the text more closely into line with the insurance industry's Solvency II

“The new draft of IORPD expands and transforms the Directive with extensive new governance requirements and a detailed plan for a harmonized EU-wide format for member benefit statements.

Directive, to update the Directive and to strengthen the Single Market by encouraging the development of cross-border pension schemes.

But IOPRD revision is not going to be easy, with Member States saying it is a national matter. The Commission is emphasizing the need for an EU-wide personal pension wrapper, which it believes is essential to simplify the legal, regulatory and administrative requirements for setting up cross-border pension schemes with a view to enabling employers and employees to reap the full benefits of the Single Market.

The most sensitive aspect of the original proposals – the Solvency II-based Holistic Balance Sheet approach to pension scheme funding – was widely criticized. An alliance of five governments (the UK, the Netherlands, Germany, Ireland and Belgium) opposed the plans.

As a result of this opposition, the Commission published a new draft of the IORPD in March 2014. This is much more than a revision. It expands and transforms the Directive with extensive new governance requirements and a detailed plan for a harmonized EU-wide format for member benefit statements.

The plan includes:

- Detailed governance requirements on risk management, outsourcing and internal audit.
- Scheme administrators would be required to have professional qualifications.
- The scheme would need a remuneration policy.
- Restrictions on long-term investments would be banned.
- The current requirement for cross-border schemes to be fully funded at all times is retained.
- Defined contribution (DC) schemes will be required to appoint a depository, with responsibility for safe-keeping of assets and oversight.
- The detailed prescription for the mandatory, EU-harmonized Pension Benefit Statement, to be sent at least annually to every scheme member, will cover everything from total capital expressed as an annuity per month (for DC schemes), to risk profiles of investment options, to a breakdown of costs and charges.
- Member States will be required to bring the new Directive into force by December 2016.

The baton has now passed to the European Parliament, which began its scrutiny of the Directive in March 2015.

Personal pensions – the third pillar

While most of the attention of policymakers remains on first and second pillar pensions, there are also pockets of discussions on reform of the personal pensions market.

In the **UK**, the insurance industry dominates the personal pensions market. A number of factors have led to this, not least a requirement (now removed) for individuals to purchase annuities with their pensions pots and tax breaks. At the end of the last parliament, the government announced a fundamental policy rethink, which caused ripples of concern in the insurance industry. For the funds industry, however, it created opportunities for managers to compete in the marketplace by offering income drawdown funds for investors in retirement. More detail on tax and regulatory changes is awaited, but a number of fund managers are already launching new products for this marketplace.

Tax-free savings – thresholds are rising

To further encourage investment and savings, some jurisdictions are expanding tax-free accounts. These types of accounts have long existed in countries such as the **UK**, where first the Tax-Exempt Special Savings Account (TESSA) and Personal Equity Plan (PEP) schemes and more recently the ISA have been popular successes. Following recent changes, UK savers can now shelter up to GBP 15,240 this tax year in ISAs, which allow savings in shares, bonds and cash.

South Africa is a new arrival to the tax-free arena. In March 2015, the Financial Services Board of South Africa outlined how its tax-free collective investment scheme (CIS) in securities, property and participating bonds would work. The scheme introduces a tax-free investments and savings accounts (TFSA) with the aim of promoting an increase in household savings and in turn reduce reliance on debt and early access of retirement fund savings.

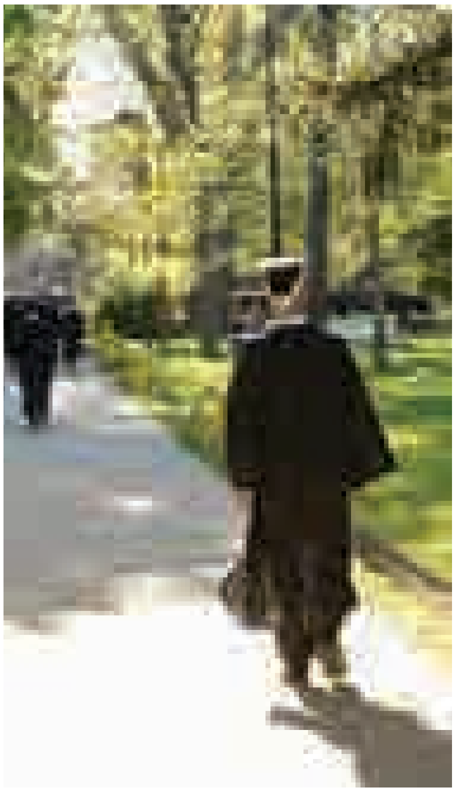
Investments in TFSAs are free of all forms of taxes, including capital gains tax, tax on dividends and interest and tax on withdrawals. Contributions are subject to an annual limit of ZAR 30,000 and a lifetime limit of ZAR 500,000. The accounts are extremely liquid, with disinvestment possible at any time. However, to discourage withdrawals, the Government is prohibiting the reinvestment of withdrawals.

Providers will have to shoulder a considerable administrative burden – monitoring contribution limits, reporting to the registrar and accounting for transactions in line with the regulations.

In **Canada**, Finance Minister Oliver's 2015 budget increased the Tax-Free Savings Account limit from CAD 5,500 to CAD 10,000 for each taxpayer. This will provide Canadians the opportunity to accumulate savings without tax penalties and will also benefit older people who can reinvest income in a tax-sheltered saving plan, including taxed funds withdrawn from the Registered Retirement Income Funds. The federal government introduced Tax-Free Savings Accounts in 2009, and doubled annual contribution limits in the 2015 federal budget to encourage saving by individuals.

In **Japan**, tax-free savings were brought to the masses in 2014. Nippon Individual Savings Accounts (known as the NISA) are based on US tax-free accounts and the UK ISA, with exemptions for capital gains and income tax.

But take-up has been slow and policymakers are now trying other means to prise money from individuals' banks accounts and encourage investment in the sluggish Japanese economy. First, the exemption limits are likely to be increased from January 2016. In addition, citizens will, from 2016, be able to open a NISA in the names of their children and grandchildren. This has echoes of the Junior ISA which was launched in the UK in 2013. It is a way for countries to transfer wealth from their comfortable elderly populations to the younger generation.



The new NISA contains restrictions though: it must be used to fund education or housing, and the standard of proof will be high.

The **US** is also encouraging saving for young people. Its so-called 529 college savings plans are being enhanced to give them more appeal. In May 2015, the Senate Finance Committee drew up a bill that would allow students to save tax-free for a computer used for college – a feature that was added temporarily to 529 plans in 2009 and 2010. However, this time, the computer would have to be used primarily by the student and not by the student's family.

5. Some barriers to fund distribution are falling, but others are rising

Key points

- New fund passports are lowering cross-border barriers within regions, but raising them for foreign managers in those markets.
- Many previously acceptable distribution practices are now unacceptable, although regulators are adopting a variety of approaches.
- Regulators are unrelenting in the drive for greater and better transparency of costs and charges.
- The complexity of products sold in retail markets is under scrutiny, with "suitability" as a particular focus.
- Technological opportunities to develop digital distribution channels are at odds with regulatory moves to restrict execution-only distribution.

Regulation is both lowering and raising barriers to the cross border distribution of investment funds.

Some barriers to distribution within regions are being lowered. The internationalization of the renminbi and the Asian regional passport initiatives create wider distribution opportunities within the region. On the other hand, European UCITS have found it more difficult to register and distribute there than in the past.

Within Europe, national discretion to adopt additional measures to protect consumers over and above the requirements of MiFID II are likely to create more obstacles to distribution, and ESMA's proposed approach to the categorization of many funds as "complex" may stymie investment managers' efforts to embrace developments in digital distribution.

Meanwhile, many jurisdictions await news of whether the European Commission will activate the AIFMD third country passports for managers and funds, what the process will be for adjudging a third country's regime to pass the passport test and whether we will see the demise of national private placement regimes.

The Volcker Rule (a section of the wide-ranging Dodd-Frank Act) continued to impact non-US funds. Until June 2015, there remained uncertainty about its application, in particular for managers owned by, or affiliated to, US banks.

Easing funds' access to markets

A significant distribution opportunity is provided through the Mutual Recognition of Funds (MRF) scheme. The scheme is part of Beijing's efforts to allow diversification for Chinese investors and to further internationalize the Chinese currency agenda. Other measures, such as Stock Connect and the RQFII scheme have similar aims.

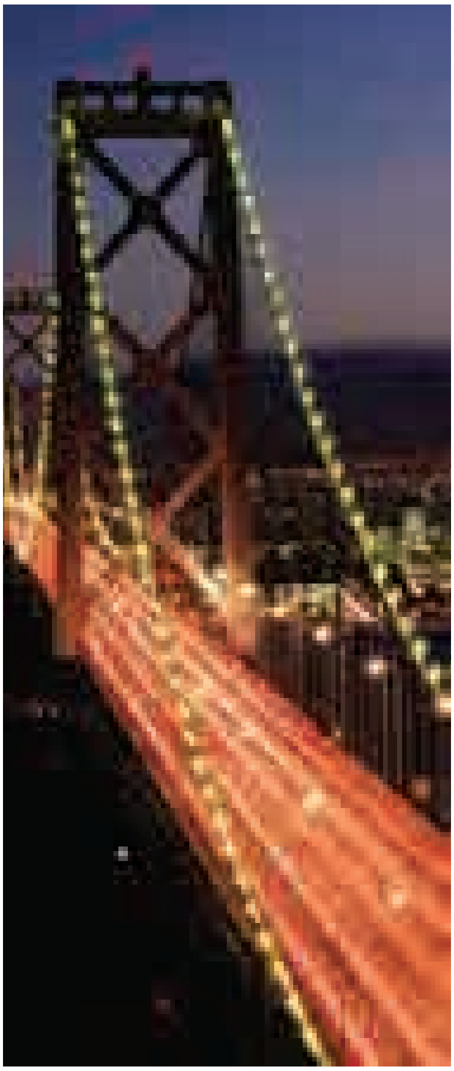
The MRF was first announced in January 2013 and a framework has now been agreed between the Hong Kong Securities and Futures Commission (HKSFC) and the China Securities Regulatory Commission (CSRC) in six key areas:

1. **Types of recognized funds** – Qualified funds will be authorized in accordance with mainland or Hong Kong laws and regulations, initially covering simple fund products. The types of products may be expanded.
2. **Eligibility of management firms** – Firms can be registered in the mainland or Hong Kong and must be licensed by the CSRC/HKSFC.
3. **Approval/vetting process of funds** – Funds will be subject to a streamlined vetting process by the host regulator.
4. **Fund operations** – Requirements relating to investment restrictions, dealing, valuation, audit and meetings must comply with the laws and regulations of the home jurisdiction.
5. **Disclosure of information** – The host regulator may demand supplementary information on content, format and frequency of update of offering documents.
6. **Investor protection** – The HKSFC and the CSRC will strengthen regulatory co-operation and assistance and clearly specify dispute resolution mechanisms.

Moves to implement MRF were stalled by the attention that policymakers had given to Stock Connect. But the HKSFC and CSRC announced at the end of May 2015 that mutual recognition will commence on 1 July 2015.

This announcement took the market by surprise, but there are already some shifts in the fund domicile landscape. There have been an increasing number of HKSFC-authorized funds – around 50 HKSFC-authorized funds were re-domiciled to

> "The HKSFC and CSRC announcement in May 2015 took the market by surprise, but there are already some shifts in the fund domicile landscape.



> “Other potential boosts to the industry come in the shape of the APEC Asia Region Funds Passport (ARFP) and the ASEAN Collective Investment Scheme Framework.

Hong Kong during 2013 and 2014 – and the HKSFC has received numerous other inquiries from fund managers wanting to re-domicile their funds to Hong Kong. This has achieved one aim – of advancing Hong Kong as a credible regional fund center – but at the expense of restricted import opportunities for non-Asian funds such as UCITS.

Pan-Asian passporting

Other potential boosts to the industry come in the shape of the APEC Asia Region Funds Passport (ARFP) and the ASEAN Collective Investment Scheme Framework (ASEAN Framework), both of which provide multilaterally agreed frameworks to facilitate cross-border marketing of funds within Asia.

In October 2013, Singapore, Malaysia and Thailand (the “Framework Countries”) agreed principal terms for the ASEAN Framework. In August last year, the ASEAN Framework was officially operational across member jurisdictions and full details were released. It is expected that Indonesia, the Philippines and Vietnam will join.

Separately, the finance ministers of Australia, South Korea, New Zealand and Singapore signed a Statement of Intent in September 2013 to develop jointly the ARFP. In February 2015, the ARFP Working Group released a joint consultation paper with the draft rules and operational arrangements, with a view to implement the ARFP by 2016.

It is not clear whether, and if so how, these different fund passport regimes will work side-by-side. Also, it is notable that certain significant jurisdictions in the region are not involved in the first wave of talks. However, it is expected that the passports will help Asia develop its regional investment management industry. The pace of change may be hampered by the lack of political, economic and tax harmony across the region, but is likely nevertheless to come at the expense of non-Asian funds seeking to export to the region, such as UCITS.

Non-US funds impacted by the Volcker Rule

One section of the extensive Dodd-Frank – the Volcker Rule – concerns the operation of “covered” funds, the definition of which excludes US mutual funds but initially did not exclude their non-US equivalents. The Rule imposes stringent requirements on banking entities’ involvement with such funds, even down to the naming of funds.

After much lobbying by non-US fund industries, the final regulations

The implications of the regional passports

Local investment managers
The opportunity to sell a product in more than one market of the region and the potential to develop more sophisticated products with a higher ceiling on AUM growth

Global investment managers
Through a single regional office have access to a huge retail investor base and more straightforward marketing process, creating economies of scale

Framework jurisdictions
Propel the growth of an end-to-end asset management industry

UCITS
A trend away from UCITS as the dominant force in Singapore, Hong Kong and other Asian countries

Capital markets
Funds passporting can recycle savings locally and deepen Asia's capital markets

Investors
Diversification of investments, greater product and investor choice, and potentially more competitive manager fees

Source: KPMG International 2015

implementing the Rule exclude non-US regulated retail funds (such as UCITS) from being covered funds, thereby allowing banking entities generally to sponsor them without restriction. However, non-US fund managers that are owned by or affiliated to US banks were concerned that their funds might still be caught under the rules as "banking entities". The Rule's definition of "control" suggests that non-US retail funds, regardless of their legal structure, could be deemed to be controlled by the banking entity that sponsors them, impacting the provision of investment management, administrative and other services provided to the funds by group companies.

As a result of industry lobbying, five different US Volcker agencies finally announced in June 2015 an amendment to enable managers to seed new funds.

AIFMD – a hybrid

The AIFMD can be considered hybrid in that it both raises and lowers barriers to distribution.

It raises barriers in the sense that investment managers from outside the EU will for only three more years be able to rely on national private placement regimes. Thereafter, non-EU managers and funds will have to register with one of the national regulators and be subject to the AIFMD requirements. Some EU countries have already removed or tightened their private placement regimes and there is evidence that non-EU funds and firms are avoiding the EU where possible due to the increased disclosure demands, especially on remuneration of the manager and the heightened regulatory reporting burden.

However, the AIFMD also lowers barriers in that it provides a passport across the Union for funds to be sold to professional investors. And, importantly, it delivers the ability for EU investment managers to have one AIF manager that can manage funds domiciled around the Union. It took three years from the UCITS Management Company (ManCo) passport being enacted before the first single EU ManCo was seen. It remains to be seen how quickly firms will rationalize the number of AIF management companies in their groups.

It will also be interesting to see whether AIFs can enjoy the same cross-border distribution success as UCITS. AIFs do not yet have wide market recognition, in part because they are not homogeneous – the AIFMD is not a product regulation as such. However, fund managers believe they are

Australian industry decides to self-regulate

Australia's Future of Financial Advice (FoFA) was launched in 2014 as a response to a spate of mis-selling scandals that had angered public opinion. The FoFA reforms aimed to improve the trust and confidence in financial advice while improving availability, accessibility and affordability. Central elements of this included the banning of conflicted remuneration, a duty for advisers to act in the best interests of clients and an obligation to renew ongoing fee agreements with clients.

Unfortunately for the regulator, FoFA was almost immediately discredited by further mis-selling episodes in Australia. As a result, the industry itself decided to act and create a code of conduct in order to stave off further criticism. The main target was advisors – developing more professional behavior through education and codes of practice. Another aspect to the code is transparency – firms are increasingly bowing to pressure to disclose the details of all their advisors on external websites and to seek customer ratings for each.

Although the changes were brought about through adversity, the code is viewed as more powerful for the fact it was devised by the industry and not by regulators.

gaining traction already. The Luxembourg regulator said at the start of the year that it had received more than 500 AIF notifications from across Europe. A large proportion of these are from Germany, the UK, the Netherlands and Sweden.

Incentivizing distribution: what was acceptable is now unacceptable

Many territories are moving towards regulation that seeks to ensure distributors act in the best interests of the end-customer and that product manufacturers, including fund managers, cannot bias providers of financial advice by payments or other forms of incentive. In many cases this is being enacted through bans or restrictions on commissions, which have a direct impact on the way in which funds are distributed and the charges that can be paid out of the fund.

In **Europe**, this move started with the UK's Retail Distribution Review (RDR) and the cudgel has been taken up by MiFID II, which imposes bans on commission paid to independent financial advisers and wealth managers. These moves will increase transparency and could have a substantial impact on the distribution landscape and the cost structure of the industry. And RDR is spreading more widely, with versions of it already created in **India** and **Australia**.

However, bans on commissions are not the only way the issue has been tackled by regulators: in the EU there is also a focus on non-monetary inducements, such as hospitality; while **Canada** has taken a different approach and introduced an explicit best interest rule for dealers and advisers; and some countries have focused on mandatory qualifications for financial advisers.

In **South Africa**, RDR has been initiated by the FSB after it expressed concern that customers are still, despite previous regulation, being sold products that are not appropriate for their needs with brokers being tied to a specific product provider.

The FSB acknowledges that the environment may become challenging for smaller players as their remuneration structures may be less lucrative as a result of commission scales being regulated. Intermediaries may also be impacted, as they were post-RDR in the UK, where many independent financial advisers exited the industry. However, it is notable that the number of UK advisers has now increased and they are qualified.

In **Canada**, the three-year phase-in of the cost and performance reporting regime put in place by the CSA has begun, which will make more explicit the actual cost of investment advice and asset management services paid by clients. The CSA also remains focused on the fees charged by the asset management industry, recently launching an analysis of mutual fund fees in Canada, with large data requests being sent to industry participants; there is the possibility of an imposed ban on trailer fees by 2016.

Similarly, the **Brazilian** regulator requires the distributor to inform its clients of its total remuneration. Also, it has prohibited the rebating of administration fees by funds in which funds of funds are invested.

MiFID II's ban on inducements, meanwhile, will require managers to consider their processes and their arrangements with distributors. In its final technical advice to the Commission in December 2014, ESMA provided revised guidance on the legitimacy of inducements paid to non-independent advisers. ESMA has maintained the wording "without bias or distortion as a result of the commission being received", which will have substantial ramifications for some existing fee arrangements within banking groups.

Therefore, product manufacturers and distributors throughout **Europe**, which have so far operated on the basis of a commission-based advisory and sales model, especially in the bank-dominated distribution markets of most continental European countries, will need to review and, as appropriate, revise their business models. Cash flows will need to change, and new distribution and co-operation models will need to evolve.

Their task will be all the greater because MiFID II allows national regulators to impose stricter requirements. **The Netherlands** have already imposed a full ban, and **Denmark**, **Belgium** and **Sweden** have all signaled they will go beyond the MiFID II ban on commissions for independent financial advisers.

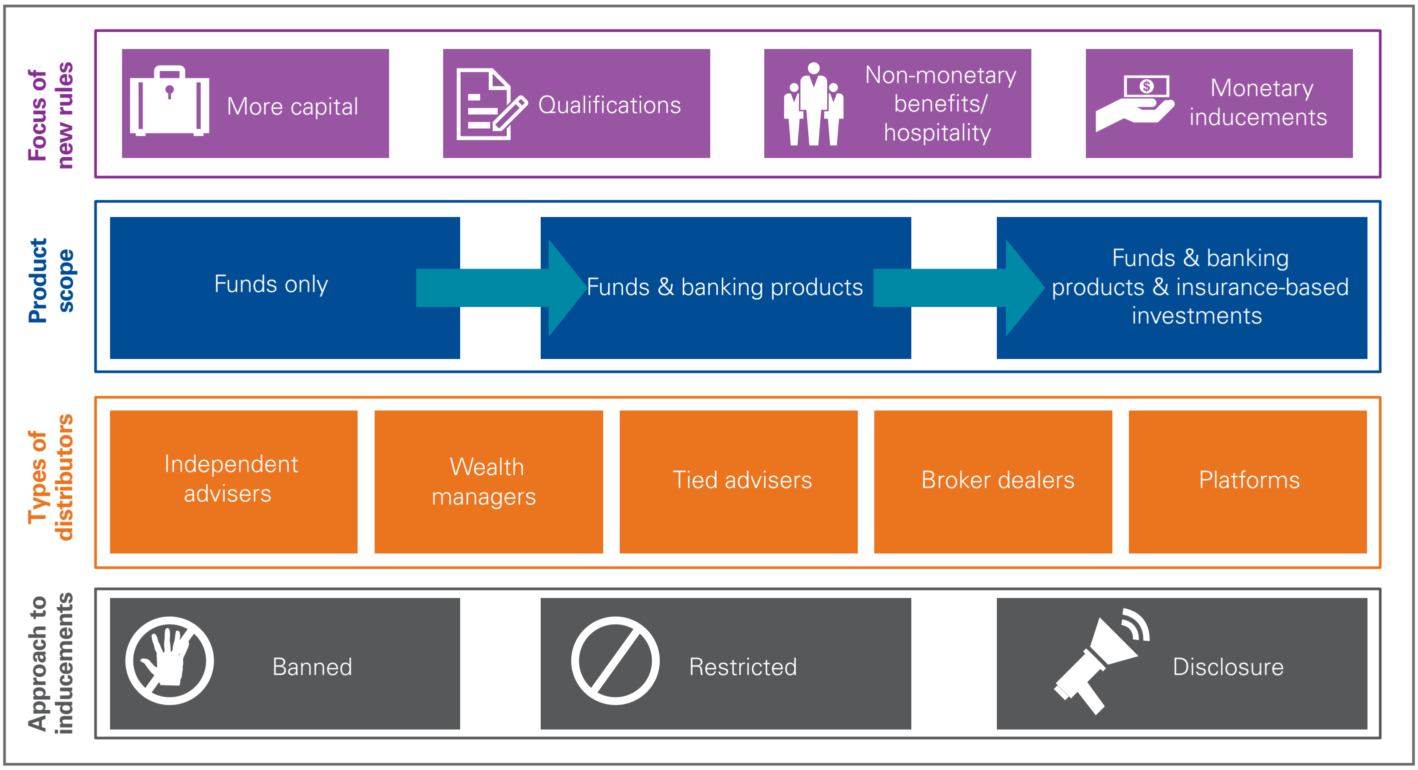
The expansion of RDR-type regulation around the globe will likely lead to a lower cost model across the investment spectrum. For instance, the mass affluent market could become self-directed, and the absence of distribution commissions based on a management fee will eliminate any incentive for distributors to sell products with high expense ratios, enhancing the environment for passive and other low-cost products. Solutions targeted to investor needs are likely to become more popular as advisors and manufacturers work to provide a better value proposition. This may provide greater opportunities for fund managers to participate more in the DC pensions market and retail savings market place.

However, many are concerned about the ability of ordinary citizens with very modest savings to access proper financial advice. They will often not have the lump sum necessary to pay an adviser's fee and may not have the confidence to take the self-directed route. Where products other than funds are not subject to the same restrictions on inducements, the funds industry is concerned that biased advice will continue.

Fear of mis-selling under MiFID II may encourage investment firms to retrain their distribution staff and educate third-party distributors. In **Switzerland**, for example, some firms are overhauling their processes before regulations change. The main focus is on remuneration of distributors and suitability tests for each client channel. Also, some fund managers are buying stakes in distributors, perhaps signaling a trend back to vertically-integrated firms.

“The Netherlands have already imposed a full ban, and Denmark, Belgium and Sweden have all signaled they will go beyond the MiFID II ban on commissions for independent financial advisers.

Distribution: a regulatory pick 'n mix



Source: KPMG International 2015

“Regulators are also grappling with how to categorize many funds. Whether they should be offered on an execution-only basis to retail investors is key to this. In other words, whether a fund is “complex” or “non-complex”.

Meanwhile, regulators continue to debate the boundary between full financial advice and guided sales, and how to regulate the latter.

Drive for transparency over costs and charges

There is no doubt that regulators will continue to demand that more and more information on costs and charges are provided to investors at the point of sale and regularly thereafter.

MiFID II has been the poster-child for progress on this front. ESMA's final advice to the Commission says that all costs and charges down the supply chain, including costs and charges within the product itself, must be aggregated and disclosed *ex ante* at the point of sale and *ex post* at least annually.

Investment firms may provide separate figures for the aggregated initial costs and charges, aggregated on-going costs and charges, and aggregated exit costs. The disclosures must be made both as a cash amount and as a percentage. On an *ex ante* basis, this will require a number of costs and charges to be estimated. Either incurred costs may be used as a proxy or the firm must make “reasonable estimations”, adjusting its assumptions in the light of actual experience.

ESMA noted the industry's concerns about overlaps and disconnect with the UCITS KIID and the development of the PRIIP KID, which are running to a different timetable. ESMA said it defers to the Commission to resolve how these inconsistencies can be addressed. Also, it recommends that the Commission review the requirements of the KIID (which does not include disclosure of underlying transaction costs) and, in the meantime, distributors should seek this information from the fund manager.

Complexity is taxing regulators' minds

Regulators are also grappling with how to categorize many funds. Whether they should be offered on an execution-only basis to retail investors is key to this. In other words, whether a fund is “complex” or “non-complex”.

There is no easy answer to this, either by regulators or from the industry's viewpoint. One important regulatory change is the tightening of rules on distribution of alternative products to retail investors. These products

are often characterized as "liquid alternative" products or "alternative mutual funds" and are the focus of policymakers worldwide.

Authorized alternative retail funds have grown strongly since 2008. There was a doubling in the number of liquid alternative funds in the **US**, and a 360 percent increase in assets managed by them[15]. And while AUM in European hedge funds have grown by 13 percent annually since 2008, so-called alternative UCITS – the European equivalent of US liquid alternative mutual funds – have grown by 40 percent a year in the same timeframe[16].

The regulators have recognized this and have reacted. The SEC performed a sweep exam in 2014 and continues its focus as outlined in its 2015 Examination Priorities.

Meanwhile in **Europe**, the popularity of "alternative" UCITS created heated debate among policymakers over whether their apparent complexity was suitable for the retail investors or should even be allowed in UCITS at all. The investment strategies of such funds were curtailed in 2013 by guidance from ESMA, but the guidance is not mandatory and not all Member States have adopted it into their rules. The Commission had indicated that it would address this and other matters by a further revision to the UCITS Directive – commonly referred to as UCITS VI – but Capital Markets Union is now taking priority.

So, it is clear that the retailization of alternatives poses a number of risks, as well as opportunities. Investment firms will need to decide if they are really committed to marketing alternative products to retail investors. In particular, they must decide if an alternative strategy can be adapted to an authorized product.

Across Asia, policymakers have expressed concerns that investment funds are mutating and now carry more potential risk than in the past. In **Singapore**, for instance, the regulator is about to introduce a new complexity-risk ratings framework for investment products offered to retail investors. The products are rated based on criteria such as the difficulty in understanding the risk-reward profile and the likelihood of losing the principle investment. It is proposed that such ratings be disclosed in product offering documents. Additionally, an opt-in regime for Accredited Investors (AI) is proposed. Under this regime, financial institutions serving eligible investors[17] will need to obtain clients' written confirmation to be classified as an AI and also to explain the consequent reduction in level of regulatory protection.

Brazil has taken a different approach. A rule comes into effect in 2015 that increases the responsibility of distributors of funds to analyze and clarify the profile of the fund and the characteristics of the product in order to identify potential suitability conflicts. Distributors may not promote products that do not fit the client's profile, but may sell a product deemed unsuitable if clients explicitly state that they are aware it is unsuitable.

As we would expect, MiFID II has something to say on the subject of complexity. In its final advice to the Commission on Level 2 measures to underpin MiFID II, ESMA proposes that certain types of product automatically be defined as complex. This would mean they could not be sold on an execution-only basis. In particular, ESMA suggests that all AIFs be classed as complex. The advice is causing wide-spread concern about the position of a number of nationally-regulated non UCITS funds that EU Member States have previously allowed to be bought by retail consumers on an execution-only basis. Very many of these funds are simple securities funds, including closed-ended listed vehicles. This demonstrates how wide-ranging is the scope of the AIFMD, which is too often billed as the hedge fund directive.

Under MiFID II, ESMA and the national regulators are given express powers to intervene when they see products being sold into the retail market that they believe are unsuitable for consumers or that have particular features that give rise to concern. The regulators can require firms to change specific features of the product or the way it is marketed, or withdraw the product from the market.

Distribution – destined to remain in flux

Distribution is a highly complex issue because of the different investment strategies, investment vehicles and investment regimes in existence. It is possible that rules on distribution will never be entirely comprehensive or clear.

The challenges of distribution for investment managers are increased by intermediation. Most fund management is intermediated and it is not easy to know who the end-investor is and what they need. But that does not mean that the industry can stop trying. Regulators and clients will expect nothing less.

Savers and investors are changing habits, not least in the way in which they expect to buy financial products. To keep pace, fund managers need to re-assess their digital capabilities and distribution strategies. Meanwhile, however, the regulatory trend is to narrow the products that can be sold on an execution-only basis.

Also, some regulators are just beginning to review their rules on the marketing of financial products. In the **UK**, for example, the FCA has issued guidance on financial promotions via social media.

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15 Source: The Hedge Fund Law Report, 6 Nov 2014

16 Source: Deutsche Bank – *From Alternatives to Mainstream Part Two*

17 Eligible investor is defined as an investor who meets any of the criteria stipulated in the accredited investor definition.

6. Data: regulation demands step – change in reporting

Key points

- The regulatory data challenge for investment firms is significant and growing.
- The emphasis on reporting may warrant firms building data warehouses and requires major project management effort to source data.
- Most firms are dealing unilaterally with the data challenge; in only a small number of countries is the industry acting collectively.
- Firms can master their data needs by building a long-term data architecture strategy, to move from incremental cost to embedded value.
- Once companies establish better data architecture and more mature analytics, they can shape answers to business-critical questions.

The data challenge for investment firms is significant and growing. A wide and increasing array of data demands – from clients, from issuers, from market counterparties and infrastructure, and from official bodies – is dizzying. Evolving rule changes regarding anti-money laundering (AML), know-your-customer (KYC) and the on-boarding of clients in general are testing the systems of even the most sophisticated investment management firms.

The emphasis on reporting may warrant firms building data warehouses and requires major project management effort to source all required data appropriately. The challenge for investment firms is not only to comply with the proliferation of data regulations, but to leverage this effort to create information repositories and flows that can directly benefit the business model.

Most firms are dealing alone with this increasing data challenge. In only a small number of countries is the industry acting collectively. Also, there is a tendency to react to each new regulatory reporting requirement in isolation. In part, this is understandable – new regulation is too often drawn up to address a specific issue without giving full regard to existing and related requirements. Also, the investment management industry is particularly affected by the extra-territorial effects of regulation: even smaller, domestic firms invest around the globe on behalf of their clients. However, the data challenge is now so significant for the industry that firms need to take a more holistic approach.

Reporting standards move closer

One day, common and consistent reporting standards may ease some of the administrative burden for investment firms. But while these standards are evolving, related data tasks are complex and time-consuming.

The Organisation for Economic Co-operation and Development (OECD) proposed a Common Reporting Standard (CRS) for the Automatic Exchange of Information (AEOI) that will see a significant increase in customer due diligence and reporting obligations. The CRS will be effective from January 2016 for more than 50 "early adopter"' countries. Financial institutions based in a country that adopts the CRS will have to implement new requirements on customer on-boarding, pre-existing customer due diligence, entity and product classification, governance and reporting.

In many ways, the CRS will impose a heavier operational burden on financial institutions than the Foreign Account Tax Compliance Act (FATCA). FATCA requires a financial institution only to identify and report US customers. The CRS requires financial institutions to report non-resident account holders of all countries participating in the Standard.

> "Financial institutions based in a country that adopts the CRS will have to implement new requirements on customer on-boarding, pre-existing customer due diligence, entity and product classification, governance and reporting.

The Galgo System – a standard data format?

In **Brazil**, the Galgo System project has continued to develop. Although not required by regulation or law, this project was instigated through discussions in ANBIMA, the self-regulatory body for the investment management industry, and is being implemented by a consortium of fourteen of the large financial institutions.

The Galgo System aims to provide standard data formats for the fund industry as well as a platform through which the regulators, managers, administrators, custodians and other parties are able to access this information. In addition to providing a single source for key pieces of data, the system will greatly help the exchange of information in the fund-of-funds market.

> “CRS provides a number of definitions that differ from FATCA, which could increase the number of financial accounts and lead to a different classification of account holders and investors under each regime.

In addition, CRS does not provide the option of electing a *de minimis* threshold for individuals, therefore increasing the number of customers in scope. It also does not provide all the exemptions available to low-risk financial institutions under FATCA, bringing more financial institutions in scope. Furthermore, CRS provides a number of definitions that differ from FATCA, which could increase the number of financial accounts and lead to a different classification of account holders and investors under each regime.

Of more than 100 jurisdictions entering into Intergovernmental Agreements (IGAs), only about 20 have so far enacted enabling legislation and guidance. Of those few jurisdictions with IGA guidance, the rules vary significantly. And none of the early adopters of CRS had by Q1, 2015 issued guidance even though it will apply from 1 January 2016.

The deadlines for entities to be compliant across both FATCA and the CRS are stretching organizational resources and the lack of clear guidance in many jurisdictions makes building systemic solutions to meet these deadlines a significant challenge.

Moving towards integrated reporting

Source: “Automatic Exchange of Information - The common reporting standard,” KPMG International 2014

Pensions reporting – Australian style

The pensions industry is under scrutiny everywhere, but probably nowhere more than in **Australia**.

The Australian Prudential Regulation Authority (APRA) has released 31 reporting standards for the superannuation industry. Of these, 26 are final reporting standards and five more are being released for consultation.

Between 2013 and 2015, APRA released a number of final reporting standards for superannuation. Since the release of those standards, APRA has continued to receive feedback from industry on a range of implementation issues, and there have also been a number of developments in the superannuation regulatory framework. As a result, over this time APRA has publicly released on its website 95 frequently asked questions (FAQs) with additional information relating to superannuation reporting.

The 26 final reporting standards released in Q1 2015 incorporate minor changes from the material covered in these FAQs. These final standards commence on either 30 June 2015 or 1 July 2015, as specified in each standard.

MiFID II: nowhere to hide

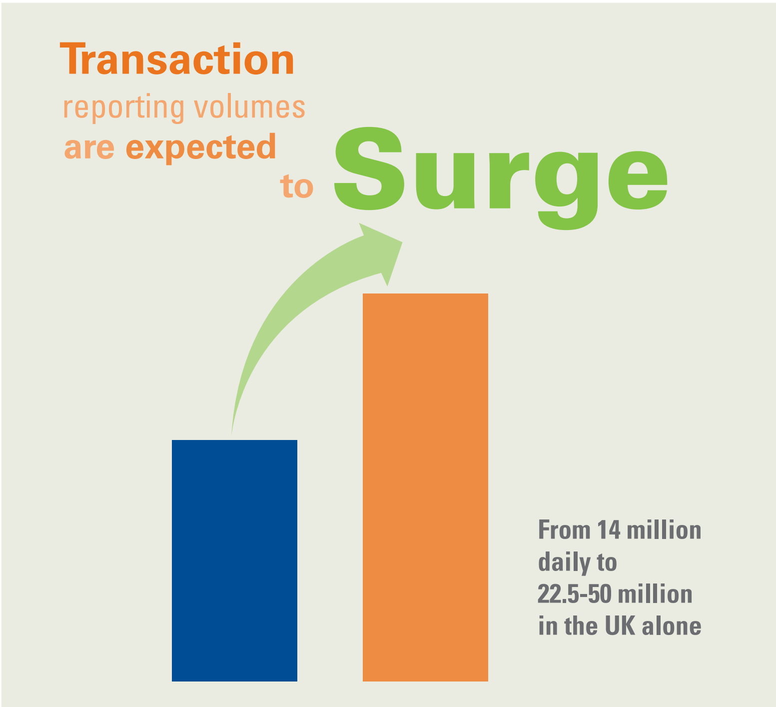
The MiFID II reporting requirements are numerous and one aspect of the Directive has the potential to create duplication with another. The wide scope of the Directive means data and reporting could run into requirements from EMIR (OTC derivatives) and the AIFMD.

There are also data management issues arising from the required disclosures to clients regarding best execution and to fund investors of the aggregate costs and charges within the product and along the distribution chain (described in Chapter 4). In some areas these disclosure requirements contradict those in the existing UCITS KIID and in the proposed PRIIP KID for other retail funds, structured products and insurance-based investment products.

Despite the lack of detailed rules or guidance on methodologies, especially in relation to assumptions used to calculate *ex ante* disclosures, it is essential that firms – whether distributors or product manufactures – begin to plan for implementation of these requirements. Data may need to be imported from different systems and departments within the firm; arrangements will need to be made to receive necessary data from other firms involved in the supply chain and to pass information on to the next firm in the chain; an internal process for agreeing necessary assumptions needs to be established; and the format of the disclosures needs to be agreed.

The new transaction reporting requirements under MiFID II/MiFIR build on the existing MiFID I requirements and

> “The Australian Prudential Regulation Authority has released 31 reporting standards for the superannuation industry.



Source: KPMG International 2015

> "The detailed rules will not be finalized until late 2015, but the direction of travel is clear and there are unlikely to be widespread changes to the draft issued by ESMA in December 2014.

reporting infrastructure, but they cover more instruments and products and more types of transactions. Interest rate, commodity and FX derivatives will no longer be exempt from reporting, and all instruments traded on Multilateral Trading Facilities (MTFs) and Organised Trading Facilities (OTFs) will become reportable.

Also, the number of fields to be reported for each transaction will increase from 28 to more than 80. For example, a trader or algo identifier will be needed, and a short selling indicator. Standard indicators such as the Legal Entity Identifier (LEI) will replace the existing Bank Identifier Code (BIC) /Floating Rate Note (FRN).

The requirements will be challenging for all industry stakeholders, including national regulators, automated reporting mechanisms (ARMs), trading venues and all market participants. For example, investment managers will no longer be able to rely on brokers to report transactions, but will themselves have to report trades in which they are the "seller".

The detailed rules will not be finalized until late 2015, but the direction of travel is clear and there are unlikely to be widespread changes to the draft issued by ESMA in December 2014.

Systems and processes will need to be adjusted, and investment firms will need to ask themselves:

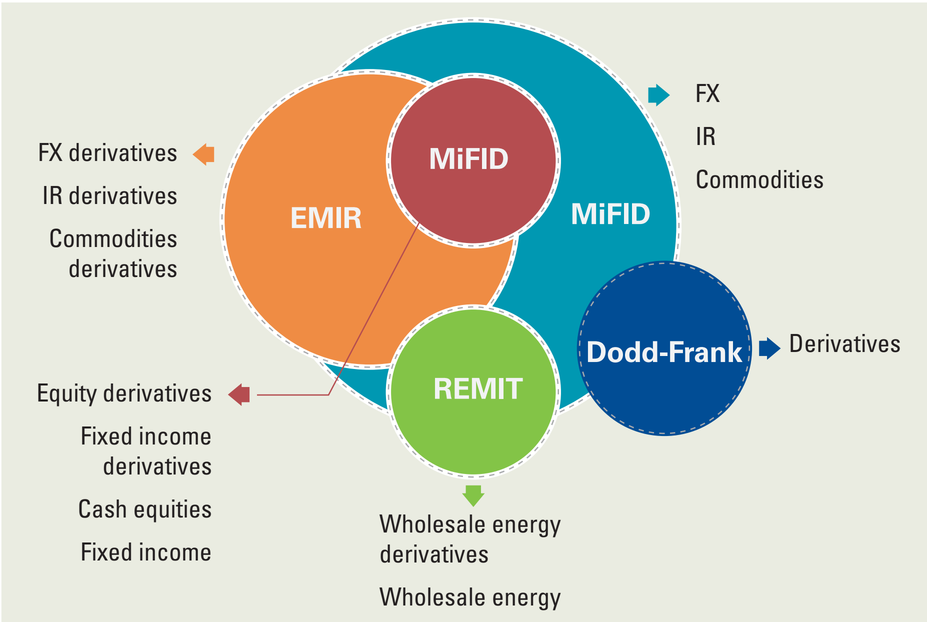
- Can I identify all products within my clients' portfolios that will meet the new MiFID definitions?
- Do I have the capacity and budget to store and retain relevant telephone conversations and electronic communications for five years?
- Can I source the data for all the new transaction fields? Do I need more than one data warehouse?
- Can I obtain more static data and referential data from clients, including end-client legal identifier?

Responding to MiFID II

All areas of firms will be impacted by MiFID II – front and back offices, operations and IT, compliance and even HR.

Firms will have to start sourcing new data elements and extra flags. Because some of the data fields overlap between the different regulatory legislation, firms will need to combine data warehouses to capture data for trade repositories and ARMs without duplicating.

Firms are challenged by overlapping reporting requirements



Source: KPMG International 2015

Firms will have to build new systems (in some cases from scratch), enrich existing systems or re-engineer their technological infrastructure. Not all the required data may currently be available within the firm. For example, many of the feeds from the listed derivatives lists will probably not cover all the information that is required, and firms may not currently have all the necessary client reference data.

US reporting ramps data needs

US investment managers also face high data requirements. This can be seen, among others, in risk reporting for private fund managers, money market reform and an increase in reporting to non-traditional regulators such as the Federal Reserve Bank and the Department of Commerce on behalf of the US Treasury Department.

The US Treasury Department gathers statistical information on a wide variety of cross-border investments from US entities. So-called Tenant-in-Common (TIC) and Bureau of Economic Analysis (BEA) forms must be filed without any obligation by the Treasury to provide a notice of filing. While in existence for several years now, new forms are required each year and often without notice. That is, they are listed in the Federal Register, but not readily known to required filers.

Added to US data requirements are increasing reporting requirements from Europe and Asia including threshold, short sale and AIFMD regulatory reporting requirements. The burden is high due to the number of filings, but also to the lack of data and reporting symmetry across the filings. There is limited uniformity across the US, European and Asian regulatory reporting landscape.

The DNA of a good "data management strategy"

Investment management firms are aware of the information challenges but not always well-equipped to meet them. Many firms have grown, at least in part, by acquisitions and run multiple fund ranges. They invest around the globe and have clients in different jurisdictions and in different investor channels. As a result, a firm's systems may be equally geographically, technologically and culturally diverse.

Marginal regulatory or client demands for a different set of data will too often be handled on a standalone basis or tacked onto existing systems, whether in-house or via third party providers. Systems often do not talk to each other, with the inevitable operational risk of manual entry and re-entry of data.

Firms have tended to react in one of two ways to the endless stream of new regulatory requirements:

1. Beefing up regulatory compliance headcount.
2. Assigning additional compliance-related responsibilities to existing employees, overloading them with risk-management duties.

Harnessing data to predict flows

During the recent downturn one investment management firm experienced a substantial increase in redemptions. The firm did not fully understand the drivers behind the exits and was unable to quantify both the number of clients likely to exit and the funds at risk. To overcome this challenge, the firm used multiple data sources to produce a single-member view, and built a predictive model using previous exit data. The model predicted correctly that more than 90 percent of members in the top two risk deciles would exit. With the key drivers behind churn identified and quantified, the firm devised and put in place proactive retention strategies.

Source: *Seeking Alpha In Business Transformation*, KPMG 2014

Both these strategies are proving untenable because they lack a unifying vision of regulatory compliance, are costly and are inadequate in terms of risk management. For example, investment management firms that have not holistically evaluated their responses to new regulatory reporting requirements are now realizing they may be reporting inconsistent information to regulators. In addition, these companies are missing an opportunity to ensure consistency in their regulatory reporting and to leverage economies of scale.

Firms may need to rethink their approach to regulatory compliance and reporting. This may involve shifting front-line risk management and supervision from compliance to the business lines, allowing them to benefit from stronger central compliance units and creating business-funded project management office (PMO) functions to manage changes. When management embraces this strategy, it sets a tone that these programs are an integral part of the business and that senior management takes seriously its obligation to understand the drivers of regulatory compliance.

From incremental cost to embedded value

A "collect and send" mentality can seem the quickest answer when up against time, regulatory and client pressures. But this approach yields "cost only" outcomes.

Intelligent use of data can give firms a cutting edge. Rather than just collecting data, firms should aggregate, analyze and embed them into business decision-making. Firms can then answer key questions: Which markets? Which clients? Which products?

Huge investments in IT alone do not necessarily guarantee better information, just more of it. In this industry, what distinguishes an organization is its ability to leverage information. That capability is critical in knowing when to enter key markets and knowing when to sunset products and services in the organization's portfolio. Enhancing data management capabilities helps firms:

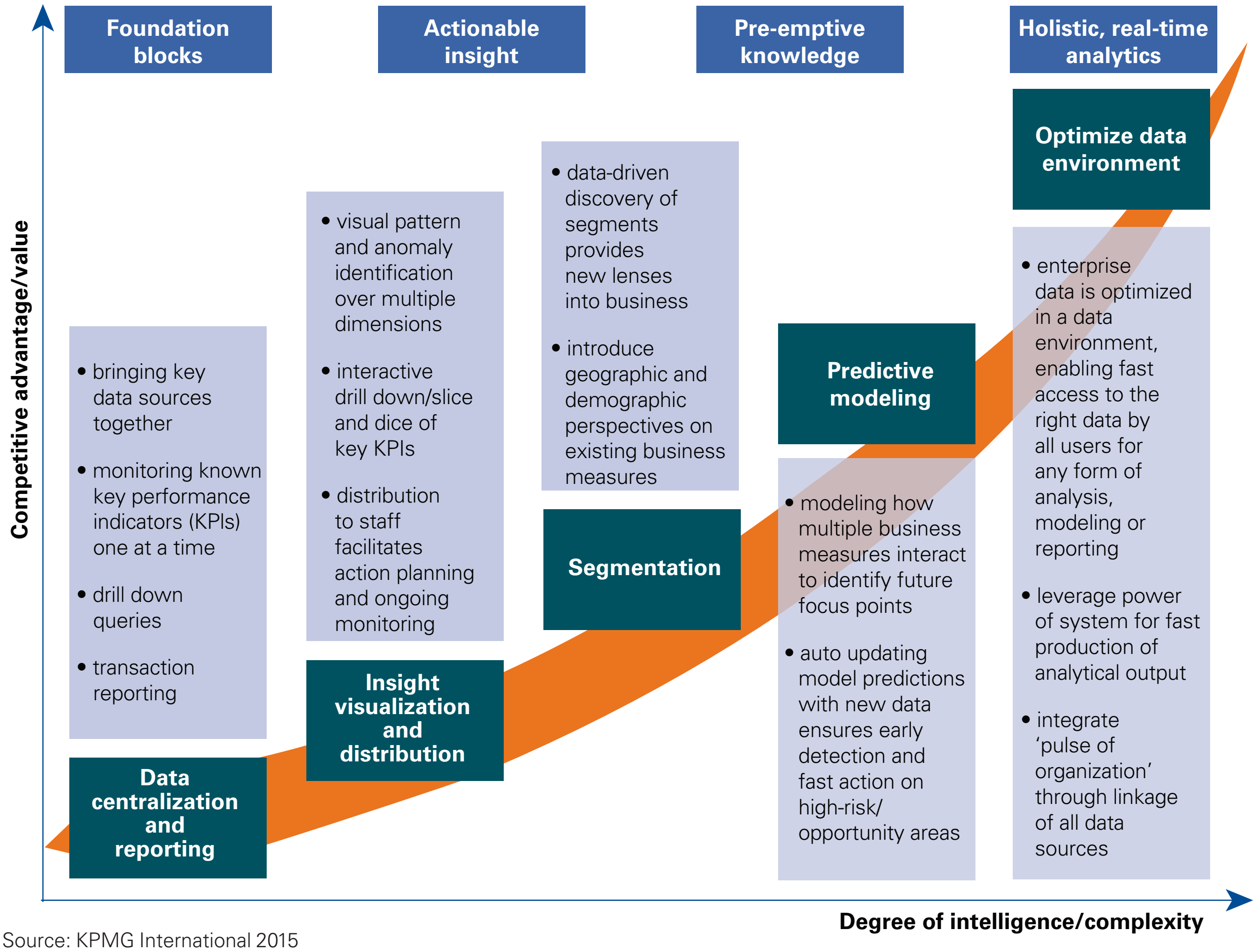
- understand where emerging market opportunities exist; and
- measure marketplace adoption of product offerings, product profitability and the relevance of existing products.

The best way for investment management firms to master their data needs is to build a long-term data architecture strategy, based on an optimized data supply chain that will keep pace with the rate of change. There are plenty of improvements a company can take to improve its analytics and reporting while building out a data plan. These are summarized in the chart on page 53.

The "low-hanging" fruit starts with internal data – harnessing and analyzing data and information inside an organization to accomplish key goals, such as improving investment performance, product design, client acquisition, operational efficiency and activity monitoring for regulatory compliance. From there, firms can better leverage third-party data and unstructured data that reside in the public domain.

Once companies establish better data architecture and more mature analytics, they can shape answers to business-critical questions.

Analytic maturity curve



Source: KPMG International 2015

What can investment management learn from Formula 1?

Both investment management and Formula 1 (F1) are judged on performance, are highly competitive and require real-time information to make optimal decisions.

To gain a competitive advantage, F1 engineers used to improve a car's performance based on their visual observations during each race. Today, cars are equipped with more than 2002 sensors, allowing teams to analyze each second of a race in real time. Over the course of a typical Grand Prix weekend, more than a billion data points are captured and analyzed.

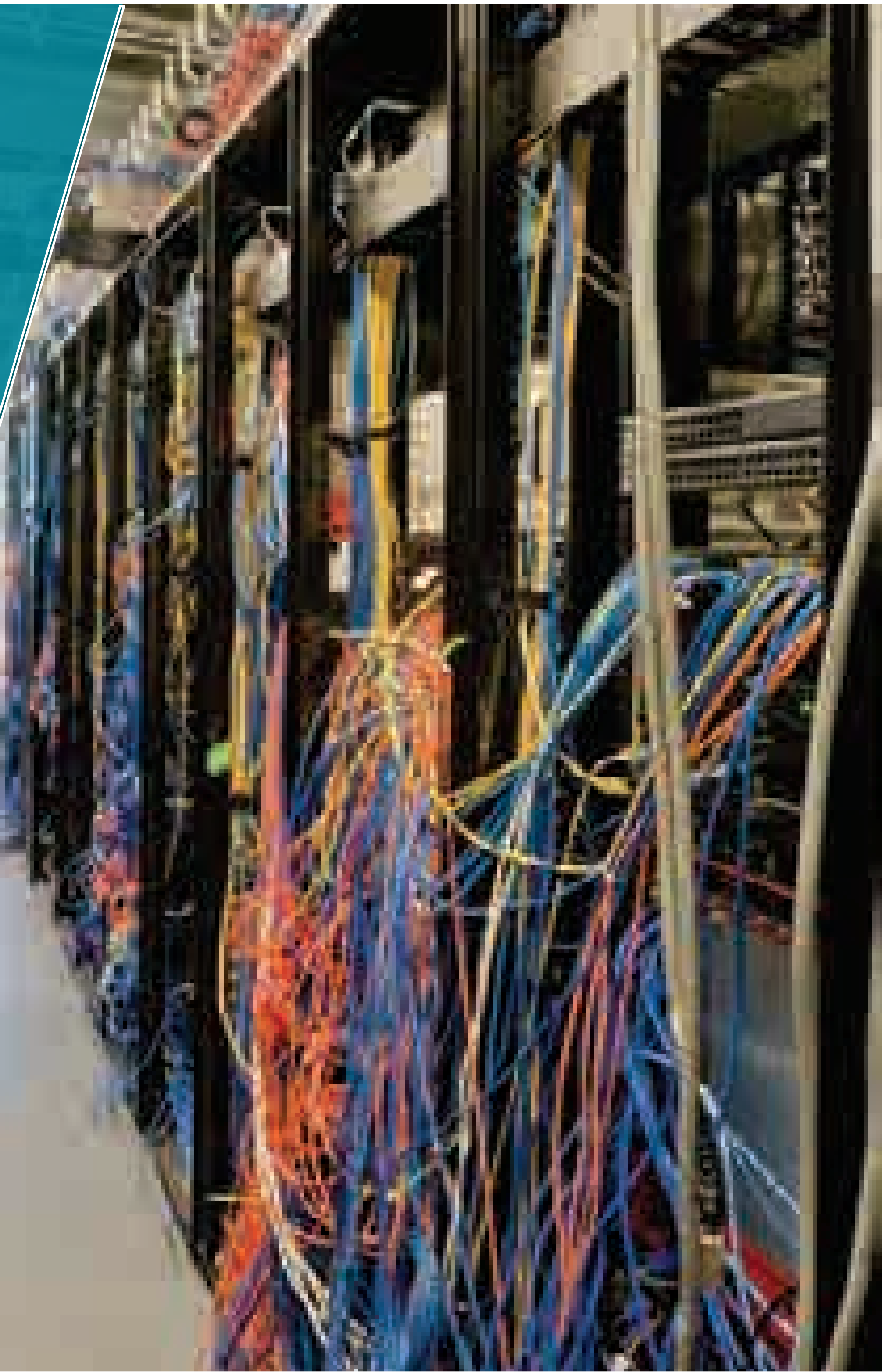
These data analytics enable the engineers to create models to predict a car's performance accurately under different conditions. And if conditions change, they are able to draw upon data from previous races to make real-time adjustments.

Speed, as well as the ability to process market data and to manage geopolitical risk, define performance winners and losers in the investment management industry. But the application of data analytics and technology is not limited to decision-making: it is also relevant in understanding one's clients.

The clients of the future will be fundamentally different in terms of their needs and expectations. Clients' changing demands will require investment managers to radically change their technological capabilities, and on an on-going basis.

Successful firms will focus on building the architecture to meet the business needs of tomorrow. Those who ignore advanced data analytics and technology will be left on the starting grid.

7. Cyber risk enters the mainstream



Key points

- Cyber risk has risen rapidly up the regulatory agenda.
- Cyber-breaches are pervasive and sophisticated, and groups of cyber-criminals are already explicitly targeting the investment management industry.
- As the nature and extent of cyber risk become increasingly clear, regulators and supervisors across the globe are responding.
- Firms and their company boards should be asking themselves key questions about their cyber security policy and capability.

Cyber risk has moved from being a largely unspecified and unrecognized risk to a key concern that is ignored at investment firms' peril.

The increasing scale of the concern is clear. Some 84 percent of respondents in the Depository Trust & Clearing Corporation Systemic Risk Barometer, published in October 2014, identified cyber risk as one of their top five business concerns. The World Economic Forum Global Risks 2014 Insight Report ranked cyber in the top three technological risks and suggested that the global cost of cybercrime may then have reached as much as USD 575 billion, while 800 million people had their personal data compromised in 2014.

Recent high-profile cyber-attacks against financial institutions cement the fact that cyber-breaches are pervasive and sophisticated. The investment management sector is not immune to these risks. It is now "when" and not "if" this sector will see a game-changing incident.

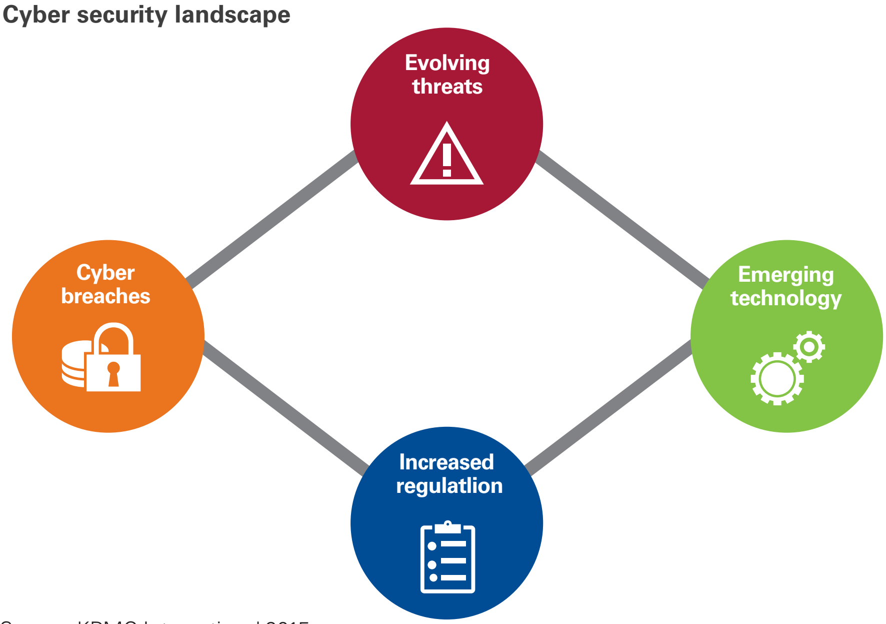
> "Some 84 percent of respondents in the Depository Trust & Clearing Corporation Systemic Risk Barometer, published in October 2014, identified cyber risk as one of their top five business concerns.

Recent cyber security breaches

- Huge customer credit card breach at large UK-based retailer
- Large online auctioneer makes users change passwords after hack
- Tech giant confirms celebrity photos stolen from cloud-based storage service
- Countless customer records exposed at a US-based bond insurer
- Gigabytes of sensitive data stolen from large investment bank

Source: KPMG International 2015

Cyber security landscape



Source: KPMG International 2015

> "Cyber risk for investment firms can range from fraud to stolen intellectual property, such as investment strategies and trading platform algorithms, data relating to ultra-high-net-worth individuals, investments or finances.

The risks are proliferating

Groups of cyber-criminals are already explicitly targeting the investment industry. Cyber risk for investment firms can range from fraud to stolen intellectual property, such as investment strategies and trading platform algorithms, data relating to ultra-high-net-worth individuals, investments or finances. In addition, there is a risk that an attacker could launch a denial of service attack to prevent organizations from doing business, to slow down the ability to complete trades or to disrupt important connections to other parties, such as market data feed providers, brokers and fund administrators.

What are we trying to prevent?

Theft of client information

- Names and contact info
- Bank accounts
- Investment details

Theft of intellectual property

- Investment strategy
- Business plans
- Trading algorithms
- M&A, JV, divestment

Theft of corporate data

- Employee data
- Payroll data

Denial of service

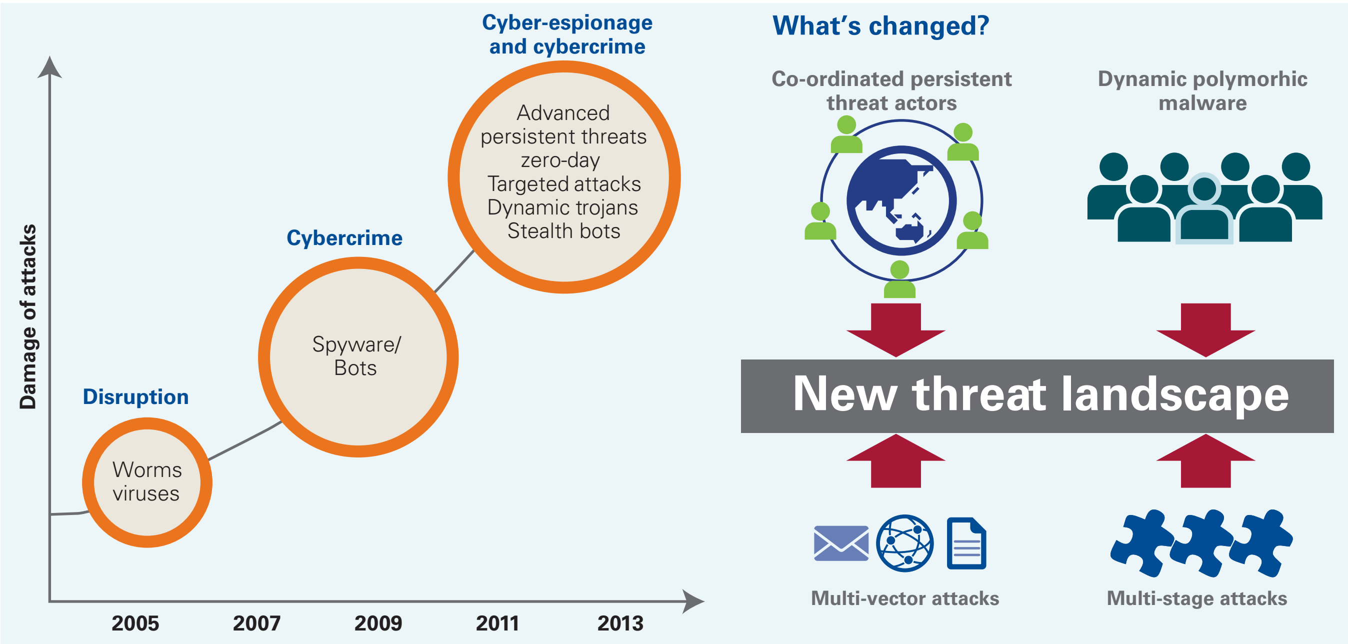
- Trading platform
- Communication channels

Supplier compromise

Front running trades/data manipulation

Source: KPMG International 2015

Evolving cyber threats



Source: Presentation at RSA Conference 2013 by Ashar Aziz, FireEye Founder, Vice-Chairman and CTO

The threat to data and systems is multi-faceted and constantly evolving. External threats come from organized criminals operating sophisticated businesses on a profit-and-loss basis, competitors using aggressive tactics to gain insights, and "hacktivists" with political or social motivation. In addition, there is a significant insider threat posed by careless, disgruntled or malicious employees.

The impact of cyber-attacks can be felt across the investment spectrum:

- An attack on a payments system may crystallize in settlement risk—that is, the inability of one financial institution to make payments to another.
- An attack may take advantage of trading complexity and capacity, targeting crossing systems or automated trading, and sparking disorderly markets through the malfunction of algorithmic programs.
- An attack on a smaller financial service provider, collective investment scheme or credit service provider may not have an immediate significant impact on financial consumers, investors or the integrity of the market. However, due to the interconnectedness of the financial system and technology, the vulnerabilities of smaller entities may also increase the vulnerabilities of larger ones and the system as a whole.

Regulators are stepping up to the emerging challenge

As the nature and extent of cyber risk become increasingly clear, regulators and supervisors across the globe are responding.

Regulators have already set out key principles. IOSCO published in 2013 a Staff Working Paper on cyber-crime, securities markets and systemic risk.

In February 2014, the **US** National Institute of Standards and Technology ("NIST") issued a Cybersecurity Framework[19], a set of voluntary standards designed for critical infrastructure companies to use in developing a comprehensive cybersecurity program. Its framework of five core functions is a recognized

"An attack may take advantage of trading complexity and capacity, targeting crossing systems or automated trading, and sparking disorderly markets through the malfunction of algorithmic programs.

[18] http://www.nist.gov/cyberframework/upload/cybersecurity-framework-021214.pdf

NIST five framework core functions

Identify – Develop the organizational understanding to manage cybersecurity risk to systems, assets, data, and capabilities.

Protect – Develop and implement the appropriate safeguards to ensure delivery of critical infrastructure services.

Detect – Develop and implement the appropriate activities to identify the occurrence of a cybersecurity event.

Respond – Develop and implement the appropriate activities to take action regarding a detected cybersecurity event.

Recover – Develop and implement the appropriate activities to maintain plans for resilience and to restore any capabilities or services that were impaired due to a cybersecurity event.

global template and has already become the standard of choice for retail and investment banks.

To date, only a few regulators have introduced new rules specifically regarding cyber risk, but they are stepping up their questioning of firms' cyber risk policies under the banner of operational risk requirements. Initial focus has been on the banking sector and market infrastructure, but the investment management sector is now moving into the spotlight.

In the **UAE**, for instance, the National Electronic Security Authority (NESA) was set up in 2014, with responsibility for developing, supervising and monitoring the implementation of the UAE's cybersecurity strategies, policies and standards. NESA conducts audits of government-owned entities, and has pledged to visit a number of banks – the primary investment institutions – around the middle of 2015.

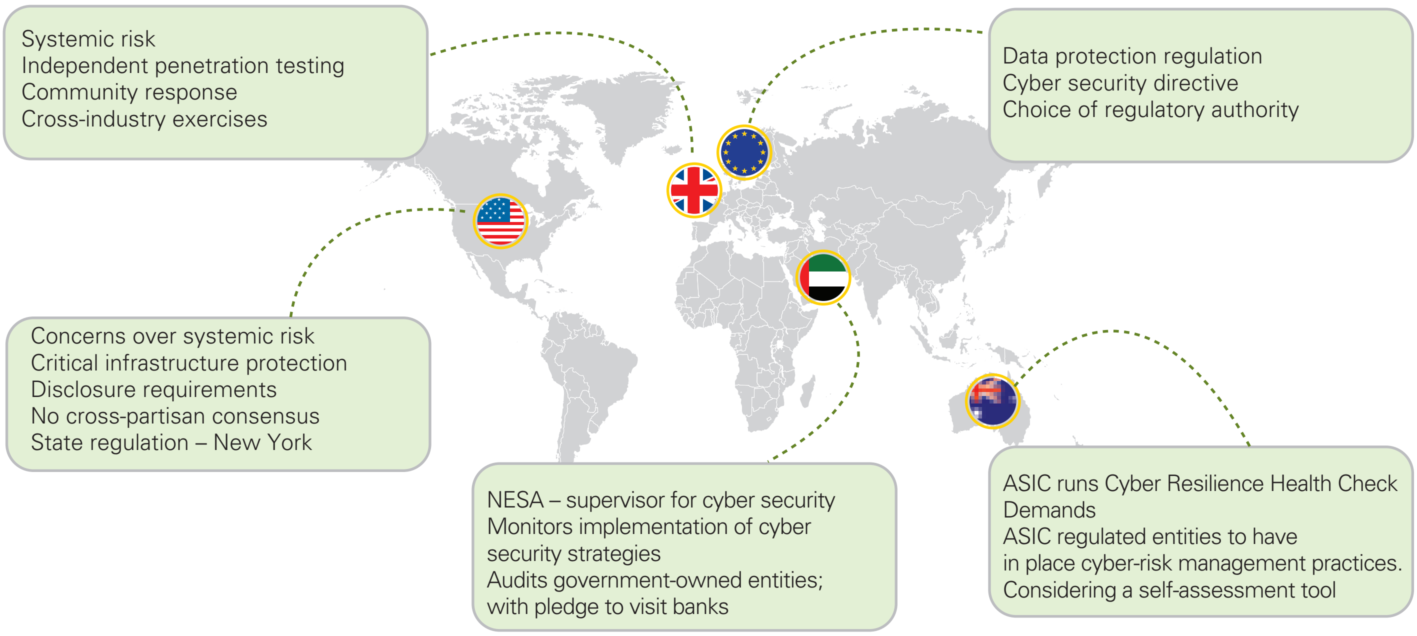
In **Australia**, cyber threats are taken very seriously by the ASIC, which has been very active in attempting to counter them. As a result of its Cyber Resilience Health Check, undertaken in March 2015, ASIC now demands that all ASIC regulated entities have legal and compliance obligations that require them to review and update cyber-risk management practices. A cyber-attack may need to be disclosed as market-sensitive information. Inadequacies in risk management systems may amount to a significant breach of obligations to ASIC.

To promote cyber-resilience, ASIC said it intends to:

- monitor market developments
- continue to engage with other government departments to identify cyber risks and build cyber-resilience
- improve awareness of the importance of cyber-resilience and increase the profile of the issues
- incorporate cyber-resilience in its surveillance programs.

ASIC is also considering providing a self-assessment tool, based on the NIST Cybersecurity Framework, to its regulated entities to help them assess their cyber resilience.

Worldwide regulatory focus on cyber



Source: KPMG International 2015

Meanwhile, in the **US**, monitoring programs by the SEC, the OFAC and others are becoming ever more stringent on organizations and their approach to cyber risks. The SEC's Office of Compliance Inspections and Examinations (OCIE) has developed a cyber-security initiative to assess cyber security preparedness in the securities industry and to obtain information about the industry's recent experiences of cyber threats.

Early in 2014, the SEC issued a cyber-security risk alert to the securities industry and has assessed 50 individual firms to check their cyber security controls. The summary of the exercise was shared in February 2015 and received a mixed response. More recently, in April 2015, the SEC's Investment Management Division released a cyber guidance update urging firms to adopt a risk-based and strategy-driven approach to tackling cyber risks. The path is paved for stricter regulatory controls in this area.

In **Europe**, the Commission has warned that cyber-attacks threaten to destabilize the EU's financial system. "New sophisticated technology for trading platforms, data warehouses and internet banking introduce a new set of challenges for cybersecurity," Olivier Guersent, the Commission's Deputy Director General for financial stability, said in April 2015. "The interconnectedness among market participants and financial institutions makes the financial sector vulnerable to disruptions from cyber-attacks and poses a serious threat — not only to them, but to financial stability as well," he said.

A proposed EU Directive includes measures to ensure a high common level of network and information security (NIS) across the Union and Commissioner Hill has asked his officials to consider whether further action could be needed.

Already enacted legislation – the EU Data Protection Regulation – penalizes businesses for information failures or breaches involving customer or other personal data. Those fines are likely to be up to 5 percent of global turnover.

In mid-2015, **Ireland** launched a review of the cyber security policies and procedures of investment management firms. Officials from the Central Bank of Ireland started to carry out on-site inspections, as a response to comments from the Obama administration in May 2015, which identified hedge funds as a weak link in the US financial system's defence against hackers and terrorists. The Irish regulator is focusing on whether firms have the correct policies and procedures in place and is ensuring that board directors are aware of their role in facilitating the appropriate governance and operational arrangements.

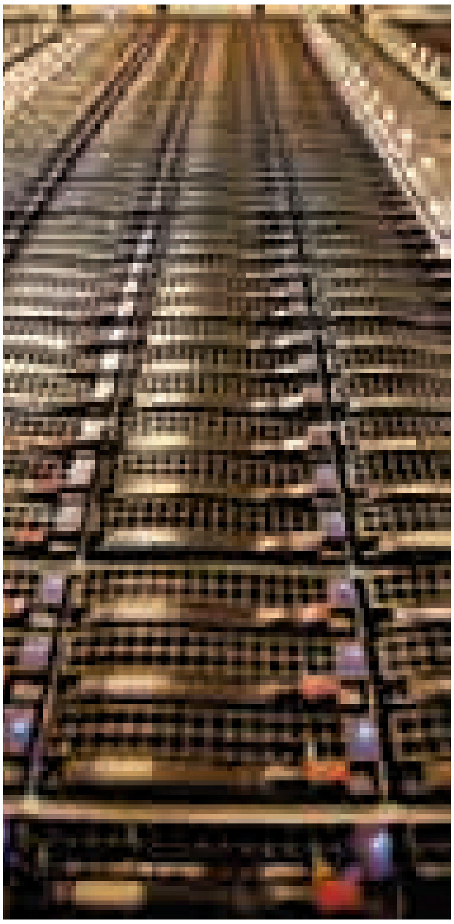
In the **UK**, the Data Protection Act requires data controllers who process customer and staff personal information electronically to register with the Information Commissioner's Officer (ICO). The ICO can issue fines of up to GBP500,000 and "names and shames" companies that suffer a serious breach.

In **Japan**, the FSA has revised supervisory guidance on the management of cyber risk.

Canada has nominated cybersecurity as a 2015 priority area. The Investment Funds Institute of Canada (IFIC) and the Canadian chapter of the Alternative Investment Managers Association (AIMA) have created working groups and seminars on cyber security. Meanwhile, the Canadian Securities Administrators (CSA) has issued staff notices reminding registrants and reporting issuers – which include investment managers and certain funds – of their requirements relative to cyber security.

How investment managers are responding

The boards of investment management firms want to be assured that the business has suitable resilience to prevent, detect and respond to cyber-breaches. According to the latest KPMG Business Instincts survey, under-investment in technology over the past six years has left many C-suites fearful that they are vulnerable to some form of cyber-attack.



Key questions for firms

- Do you have the right level of protection for your most valuable information?
- What would the impact be on your business if you suffered a cyber-security breach?
- How do you know you haven't already suffered one?
- How are you managing your suppliers to ensure they are not a weak point in your security?
- How do your cyber security capabilities compare to your peers?

This is despite considerable spending. Thirty-six percent of the survey[19] respondents to a Cerulli Associates survey are spending around USD 10 million (EUR 8.8 million) a year on preventing cyber incidents. The survey also revealed that some investment managers have employed cyber-security specialists, who report regularly to the main board of the company.

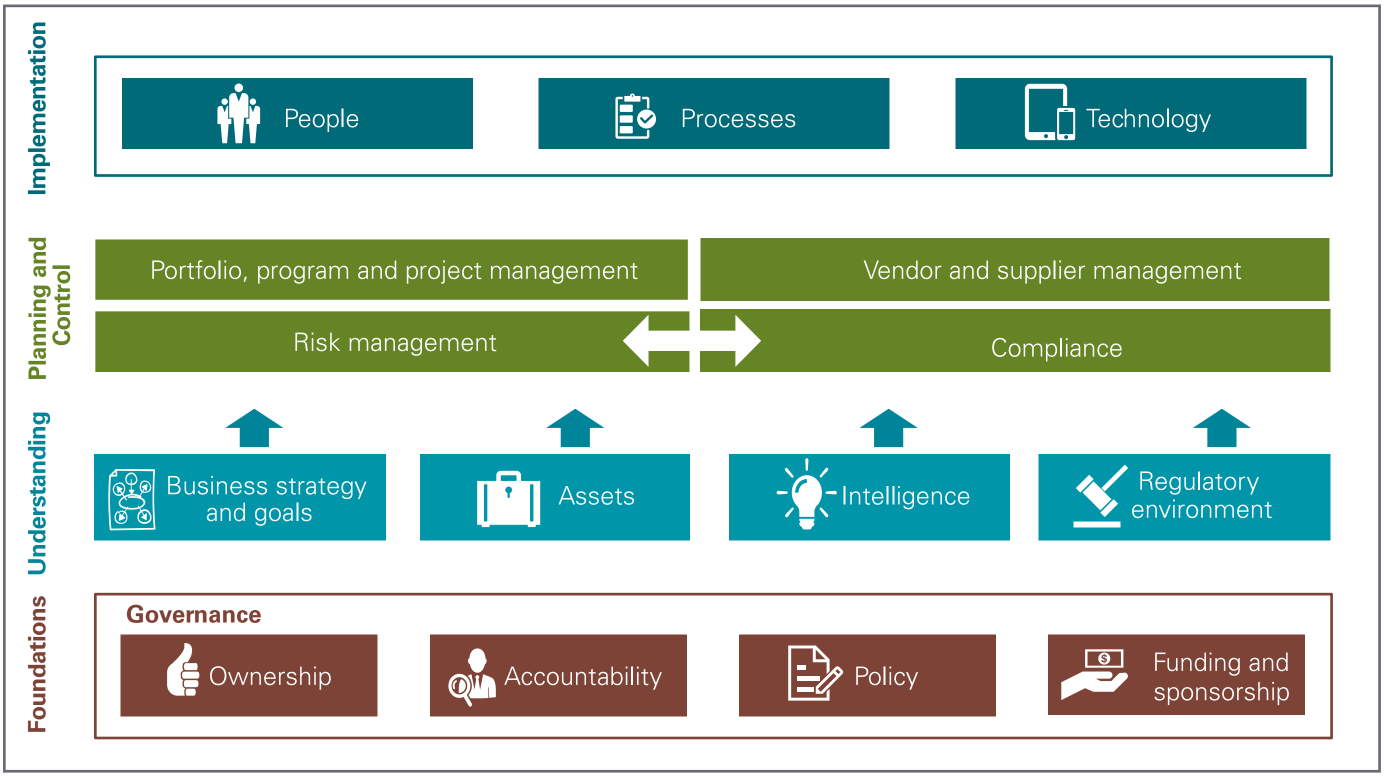
Proactively managing cyber risk has clearly become a key consideration for the C-suite, with as many as one in three senior executives saying that investing in cyber skills to protect their business is now their major concern. Organizations are typically looking to create the following capabilities:

1. **People**: The most important component of a cyber-security policy is that it must be understood by all employees. Security awareness training and developing easy to understand security policies on corporate equipment and when working remotely will position employees as a first line of defense.

2. **Processes**: An adaptive approach that focuses on speed and agility in response to an attack can prevent downtime, avoid expensive disruptive responses and maintain business operations, while also reassuring regulators, investors and industry partners. Ensuring security requirements are built into key processes such as application management, change management, user access management and patch management. Establishing security requirements in contracts and exercising the right to audit with third parties.

3. **Technology**: Implementing fundamental security controls, such as firewalls, anti-malicious software, secure configurations and security logging and monitoring will enable firms to stay ahead of the curve.

Cyber security capability model



Source: KPMG International 2015

[19] The Cerulli Edge – Europe Edition, 1Q, 2015 Issue

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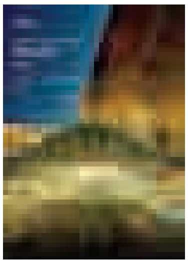
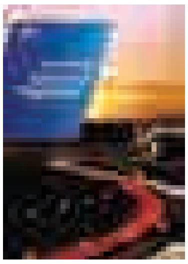
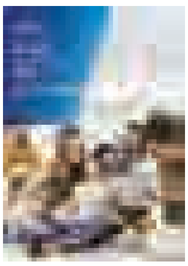


Evolving Banking Regulation
April 2015
In the current business environment, banks face a complex mix of inter-related regulatory, economic and commercial pressures that are driving changes in bank structure. This report looks at recent and forthcoming banking regulation.



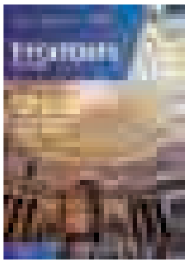
Evolving Insurance Regulation
April 2015
2015 is seeing international developments dominate regulatory change in the insurance industry. The IAIS's proposed new global insurance capital standard, the implementation of Solvency II, and the completion of IFRS 4 Phase 2, leave no doubt we are witnessing a new era in insurance regulation.

Investing in the Future
June 2014
At KPMG, we believe the investment management industry faces major challenges as well as major opportunities. In this report, we discuss the implications investment managers should consider addressing in response to the global megatrends that will affect the sector in the next 10 to 15 years.



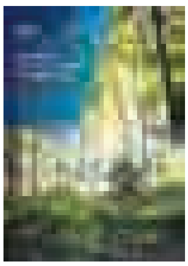
The New Inconvenient Truth
Social Media: Too Big for Wealth Managers to Ignore?
June 2015
Social media has been driving sustained and irreversible disruption in how customers stay informed, how they make decisions and how they interact with business. Wealth managers, as in other industries must quickly adapt or face obsolescence.

Evolving Banking Regulation part two
April 2015
Focuses on bank structure, and the search by many banks for a viable and sustainable future in a world where regulatory and commercial pressures are driving business model change.



Frontiers in Finance
June 2015
This issue of Frontiers in Finance illuminates some of the most pressing opportunities and challenges in the continuing fight for competitive advantage.

Automatic Exchange of Information: The Common Reporting Standard – Value Proposition
December 2014
This Value Proposition document takes a closer look at the impact of CRS and considers the steps financial institutions should take to achieve compliance cost-effectively.



Growing Up: A New Environment for Hedge Funds: 2015 KPMG/AIMA/MFA Global Hedge Fund Survey
March 2015
The hedge fund industry is in the midst of a transformation. The growth environment is constantly changing and, as a result, managers have become more focused than ever on improving performance and operational effectiveness.

Abbreviations

ADGM	Abu Dhabi Global Market
AEOI	Automatic Exchange of Information
AIF	Alternative Investment Fund
AIFMD	Alternative Investment Fund Managment Directive
AIMA	Alternative Investment Managers Association
AML	Anti-money laundering
ANBIMA	Associação Brasileira das Entidades dos Mercados Financeiro e de Capitais (Brazil)
APEC	Asia-Pacific Economic Cooperation
APRA	Australian Prudential Regulation Authority
ARFP	Asia Region Funds Passport
ARM	Automatic Reporting Mechanism
ASEAN	Association of Southeast Asian Nations
ASIC	Australian Securities and Investments Commission
AuM	Assets under Management
BaFin	German Federal Financial Supervisory Agency
Banxico	Central Bank of Mexico
BEA	Bureau of Economic Analysis
BIC	Bank Identifier Code
BIS	Bank for International Settlements
CCP	Central Clearing Party
CFTC	Commodity Futures Trading Commission
CIS	Collective Investment Scheme
CMU	Capital Markets Union
CNAV	Constant Net Asset Value
CoCos	Convertible Securities
CPA	Certified Public Accountant
CPP	Canada Pension Plan
CRD 4	Fourth Capital Requirements Directive
CRM 2	Client Relationship Management
CRS	Common Reporting Standard
CSA	Canadian Securities Administrators
CSD	Central Securities Depositary
CSDR	Central Securities Depositary Regulation
CSMAD	Criminal Sanctions for Insider Dealing and Market Manipulation
CSRC	China Securities Regulatory Commission
CSSF	Commission de Surveillance du Secteur Financier (Luxembourg)
CVM	Comissão de Valores Mobiliários (Brazil)
DIFC	Dubai International Financial Centre
DOL	Department of Labor (US)
EBA	European Banking Authority
ECON	European Parliament's Economic and Monetary Affairs Committee
EFAMA	European Fund and Asset Management Association
EIOPA	European Insurance and Occupational Pensions Authority
ELTIF	European Long-Term Investment Fund
EMIR	European Market Infrastructure Regulation
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
EuSEF	European Social Entrepreneurship Fund
EUVECA	European Venture Capital Fund
FAQs	Frequently Asked Questions
FATCA	Foreign Account Tax Compliance Act (US)
FCA	Financial Conduct Authority (UK)
FER	Fund Expense Ratio
FRN	Floating Rate Note
FSA	Financial Services Authority (Hong Kong)

FSB	Financial Stability Board
FX	Foreign Exchange
G20	Group of Twenty
GFSR	Global Financial Stability Report
HKSFC	Hong Kong Securities and Futures Commission
ICAV	Irish Collective Asset Management Vehicle
ICO	Information Commissioner's Officer
IFIC	Investment Funds Institute of Canada
IMF	International Monetary Fund
IORPD	Institutions for Occupational Retirement Provision Directive
IOSCO	International Organisation of Securities Commissions
ISA	Individual Savings Account (UK)
KYC	Know Your Customer
LEI	Legal Entity Identifier
LV CNAV	Low Volatility Constant Net Asset Value
MAD II	Second Market Abuse Directive
ManCo	Management Company
MAR	Market Abuse Regulation
MiFID II	Second Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MMF	Money Market Fund
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Schemes Authority
MRF	Mutual Recognition of Funds
MTF	Multilateral Trading Facility
myRA	My Retirement Account
NAV	Net Asset Value
NBNI GSIFI	Non-Bank Non-Insurer Global Systemically Important Financial Institution
NESA	National Electronic Security Authority
NEST	National Employment Savings Trust (UK)
NIS	Network and Information Security
NISA	Nippon Individual Savings Accounts (Japan)
NIST	National Institute of Standards and Technology (US)
OCIE	Office of Compliance Inspections and Examinations (US)
OECD	Organisation for Economic Co-operation and Development
OFAC	Office of Foreign Assets Control
OTC	Over the Counter
OTF	Organised Trading Facility
PDMR	Person Discharging Managerial Responsibilities
PEP	Personal Equity Plan (UK)
PRIIP KID	Key Information Document for Packaged Retail Investment and Insurance-based Products
QFII	Qualified Foreign Institutional Investor (China)
QIAIFs	Qualifying Investor Alternative Investment Funds (Ireland)
RDR	Retail Distribution Review (UK)
RFQII	Renminbi Qualified Foreign Institutional Investor (China)
SEC	Securities and Exchanges Commission (US)
SME	Small or Medium Enterprise
SPV	Special Purpose Vehicle
SRO	Self-Regulatory Organization
TESSA	Tax-Exempt Special Savings Account (UK)
TFSA	Tax-Free Investments and Savings Account (South Africa)
TIC	Tenant-in-Common
UCITS	Undertakings for Collective Investment in Transferable Securities

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Designed by Evalueserve.
Publication name: Evolving Investment Management Regulation – Navigating opposing forces
Publication number: 132462-G
Publication date: June 2015