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FINANCIAL SERVICES

Evolving Investment Management Regulation

Meeting the challenge
June 2011

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About this report

This report was developed by KPMG's network of regulatory experts. The insights are based on discussions with our firms' clients, our professionals' assessment of key regulatory developments and through our links with policy bodies.



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Foreword

Turning challenge into opportunity

The rapidly evolving world of regulation continues to present challenges for the financial services industry. Following our reports on *Evolving Banking Regulation* and *Evolving Insurance Regulation*, the third in this series explores the impacts of regulatory reforms on the investment management industry. Investment management firms face a similar degree of regulatory reforms to banks and insurers, some arising from the G20 initiatives following the financial crisis and some of a more local nature. So despite the good intentions of the G20 to develop a consistent and coordinated global approach to regulation, regulatory and political agendas in national jurisdictions are the core driving force of the speed and nature of regulatory reforms – so much so that the extent of the pace and change is as diverse as the global communities themselves.

This presents a tough challenge for global businesses like investment managers who are left to make sense of a patchwork of regulations, and to formulate an approach that is both robust enough to withstand regulatory scrutiny and commercially viable. Preparing for what is around the corner has become crucial to survival: this involves implementing regulatory remediation measures where timescales are tight but rules are not finalized, while remaining competitive. For some, the pace of change is threatening, the impact could be detrimental to innovation and it could create barriers to entry for small to mid-market sized players. For others, it presents opportunities for growth through new markets and products/services.

There are clearly opportunities to work within the direction of travel of regulatory change while taking advantage of growing personal savings and investments as income and wealth increase, not least in Asia. The shortfall in pension provisions and long term savings remain an opportunity in Europe and North America. There is also demand for an increasing range of products – using different vehicle structures spanning the wide range of asset classes. Moreover, the relatively more onerous implementation of regulatory rules in the West is enhancing the attractiveness of Asia in terms of business opportunities, cost efficiency and competitive advantage.

In terms of threats, while regulators are well intended in their policy making, unfortunately there are often unintended consequences. Investor protection through increased regulation, for example banning sales commissions, could lead to financial exclusion for many investors and increased costs of regulatory compliance may erode investment returns. There are difficult trade-offs here for both regulators and firms to navigate.

The challenge for the industry is achieving the optimal environment for restoring investors' trust while striking the right balance between investor protection and encouraging people to save and invest; which is a critical societal need. Economies need their populations to save in the long term if aspirations for a high retirement standard of living are to be met, without creating economic imbalances and government deficits. The industry needs to seize the opportunity to work with regulators, policy makers and investors to achieve positive, practical outcomes. With its long history of successfully complying with regulation, the industry should be reasonably placed to address new developments constructively.

While this all plays out, investment management businesses should seize the opportunities available to them as saving and investment markets continue to expand, and to do so in a way that is consistent with the shifts in regulatory emphasis and rebuilding investors' trust. Firms that will succeed in building profitable businesses are likely to be those that understand well how to combine commercial opportunities and regulatory imperatives, and are able to translate this understanding into their business and operating models.



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Executive Summary

The pace of change

The investment management industry is grappling with wide-ranging regulatory reform addressing issues from systemic risks to investor protection, transparency, governance, shadow-banking and taxation. Balancing the competing demands of various regulatory agencies is a huge challenge.

This is especially the case for globally diversified firms who need to make sense of those demands and bring them together in a comprehensive and cost effective way. While technology has been an enabler for global expansion, the many overlapping regulatory initiatives including the revision of Undertakings for Collective Investments in Transferable Securities (UCITS)¹, review of the Markets in Financial Instruments Directive (MiFID), the Dodd-Frank Act, Packaged Retail Investment Products Directive (PRIIPs) and Foreign Account Tax Compliance Act (FATCA) among others, could create barriers to growth. Addressing these initiatives and making the requisite changes to the business, will likely add more cost and complexity to the manufacture and distribution of investment products. From the [ASPAC Perspective](#), this presents further challenges for the industry, in addition to the diversity of regulation in the region.

How to protect consumers from unnecessary risk by enhancing transparency, has been at the heart of regulatory change since the crisis. This has resulted in a variety of initiatives some of which focus on improved disclosure (PRIPs) across institutional and/or **Retail Distribution** channels (e.g. the adviser registration requirements under the Dodd-Frank Act) and others such as the Alternative Investment Fund Managers Directive (AIFMD), focus on bringing previously unregulated or 'light touch' sectors (private equity and real estate) into the regulatory net. There has also been a shift, more so in Europe than other areas, towards giving regulators the ability to ban **Products**, which is a theme in the update of MiFID, giving the European Securities and Markets Authority (ESMA) the power to step in at a national and European level. Adapting to the requirements of UCITS is a major focus for all investment managers and funds from a **European Perspective** this year, with further work on strengthening and harmonizing the framework. Beyond Europe, UCITS products have been generally successful, particularly in the Asian markets and many of the changes in UCITS IV as well as those proposed in UCITS V, are to preserve the international reputation of the UCITS brand.

Shareholders, investors and regulators are increasingly demanding more accountability and stewardship from investment managers. This is driving more robust **Governance, Risk and Fiduciary Responsibility** requirements. In addition, institutional investors are raising the bar when it comes to the due diligence process by requiring more transparency and encouraging shareholder activism.

While it is generally agreed that hedge funds were not the cause of the crisis, there has been a focus in Europe and

the US on reform for the **Alternative Investments** industry. AIFMD may end up raising fees or causing fund managers to stop selling certain products which will limit consumer choice. From the **Americas Perspective**, the most notable change is to the adviser registration requirements for alternative investment managers.

A key focus of the regulations will be the internal framework for risk management and liquidity management. This could represent a culture shock especially for those private equity and real estate funds that have not had comparable experience as more traditional funds under UCITS. In all cases, the Directive will impose a structure of discipline and rigor which discerning firms should welcome. In recent years, regulatory pressure has increased on **Offshore** markets through onshore regulations, including to countries once termed as 'tax havens' that had perhaps reduced their re-locational popularity. However, the mounting costs from implementing the AIFMD, Dodd-Frank and FATCA are causing many to revisit the onshore versus offshore debate to reduce costs or to avoid regulation. Addressing the lack of transparency of over-the-counter (OTC) derivatives, insider trading and short-selling in **Capital Markets** are interesting challenges, particularly with the alignment (or lack of) between the European Union and the US. It remains that regulatory agencies will have the ultimate decision regarding the clearing and reporting of OTC derivatives.

Pensions vary around the world with some markets moving faster than others. Levels of sophistication and the ageing population in many countries impact how regulators are developing their rules. Increased pressures on cost have resulted the rapid decline of Defined Benefit schemes with a

Addressing these initiatives and making the requisite changes to the business, will likely add more cost and complexity to the manufacture and distribution of investment products.

concurrent growth in Defined Contribution – passing the risk from the provider to the individual.

The regulatory changes may be a catalyst to accelerate certain trends that have been underway within the industry. Specifically, product convergence among asset classes that traditionally have remained separate and distinct, may accelerate now that the registration requirement is no longer a barrier to entry. The unintended consequences of increased regulation could limit product choice for consumers and impact the market. **How will you meet the challenge?** How do you get your business model and compliance function fit for purpose, to address regulatory change? Understanding the totality of regulatory requirements and the strategic implications for your business is essential to putting you ahead of the race.

1. See page 41 for Glossary of Terms.



01

Retail Distribution

Rebuilding trust and transparency

There is no question that regulators have broadened the post-crisis systemic risk regulatory agenda to include product disclosure and investor protection. The public anger and resentment about the role of financial services in the crisis is high on the political agenda in many countries; trust in financial services has been particularly low, with investment and pension services ranked as the least trusted sector out of fifty different consumer markets surveyed by the European Union (EU), putting it behind the more traditionally poorly perceived sectors such as second hand cars, gambling and alcoholic drinks².

While the stock markets have largely bounced back and many investors' portfolios have recouped their losses, rebuilding trust and confidence in the capital markets and financial services has become critical to politicians in securing public support. The challenges facing the industry now are about regaining investor trust and confidence and changing of business models to deal with a changed regulatory landscape.

Beyond the measures and initiatives already being taken around the globe by governments and regulators to address sales and distribution issues, an opportunity exists to have a greater industry focus on improving transparency and confidence in the investment management industry. This includes improving investor outcomes, as well as increasing the quality of the product distribution process, for example, through defining product provider/distributor roles and responsibilities and ensuring quality of advice at the point of sale.

Achieving greater transparency

Regulators continue to try to achieve greater transparency in the way investment products are distributed through setting rules and issuing guidance. Some countries increased their focus on this following the crisis which resulted in a series of reviews of reform taking place across the EU,

in Australia, Hong Kong and India among other territories.

Distribution reform is not solely a reaction to the crisis and similar initiatives have been taking place for some time, for example in countries such as Japan, where the Financial Instruments and Exchange Act (FIEL) was introduced in 2007 to address transparency and distribution concerns.

European Union response

The proposed Packaged Retail Investment Products (PRIIPs) review aims to create a level playing field across all retail investment products through harmonized sales and disclosure rules. Many in the investment funds industry welcome these proposals, feeling they are long overdue. They believe they have been subjected to a harsher regulatory regime (Undertakings for Collective Investment in Transferable Securities – UCITS) than other competing retail investments such as insurance wrapped unit linked funds (investment bonds) and structured products.

One key aspect of the PRIIPs reform is to extend the UCITS IV Key Investor Information Document (KIID) to all retail investment products. The KIID is designed to be short (no more than two pages) and straightforward so that it can be easily understood by investors. It sets out the basic product information, which includes a summary of its main features, a risk indicator, performance history, fees and provider contact details.

By harmonizing disclosure across all retail investments through PRIIPs, it is hoped that consumers will be able to better understand and compare similar products more easily than is currently the case.

While clearly there are benefits in increasing product comparability to investors, the real difficulties faced by PRIIPs providers relate to the significant differences in national product distribution

models and the challenges in producing a common disclosure document, including risk indicators across all types of retail investments. The life insurance industry in particular has expressed concerns, but we have yet to see if sector lobbying will convince the European Commission (EC) to take a different approach to its current stance on harmonized retail investment disclosure.

Also central to the EU regulatory landscape is the review of Markets in Financial Instruments Directive (MiFID 2) which began in December 2010. MiFID 2 will take forward some of the proposals set out in PRIIPs and looks again at some of the key areas governing regulation of retail investment funds. Key proposals include:

- introducing a category of ‘complex products’ for funds that include embedded derivatives. The sales of these funds may require the investor to pass a knowledge and experience test prior to being allowed to make an investment;
- banning execution only transactions for a client if the firm is arranging a loan to facilitate increased leverage for that client at the same time. Or even the complete banning of execution only sales for some products;
- requiring intermediaries giving advice to explain whether or not they are independent. Independent advisers may be prohibited from receiving commission payments;
- requiring firms to provide additional information to investors before the transaction takes place as well as during the lifetime of the product;
- tightening up rules on inducements (but not completely banning commission); and
- introducing a more rigorous assessment of suitability and appropriateness for professional clients.

Also within the EU, similar to PRIIPs the UK Financial Services Authority (FSA)’s Retail Distribution Review (RDR) is noteworthy as a national key driver for distribution reform. The UK is unusual in the EU in terms of its intermediary distribution model because while it has tied and multi-tied³ advisers, it also has Independent Financial Advisers (IFA’s) who can provide advice across the ‘whole of the market’. Currently IFAs are responsible for 80 percent of retail fund sales. Starting in 2006, the RDR aims to improve the quality and consistency of advice received by consumers by banning commission, broadening the definition of independent advice and by raising the minimum qualification standards for advisers. The impact of this initiative is expected to be significant for fund distribution. UK fund managers need to act now to get their products and their businesses ready in time to meet the challenges of the new environment and the implementation deadline of 1 January 2013.

US impacts

In the US it is expected that the fiduciary standards currently applied to investment advisers will be applied to broker dealers in the near future. This higher standard will affect governance and compliance models in broker dealer firms (see Chapter 3 **Governance, Risk and Fiduciary Responsibility**), which may in turn impact distribution models going forward. For example, a higher fiduciary standard may increase the responsibility of brokers offering products to clients in the context of product appropriateness and suitability including risk assessment and alignment.

2. *The Monitoring of Consumer Markets in the EU*. Growth from Knowledge, 2010.

3. A ‘tied’ adviser is one that only sells products from a single institution. A ‘multi-tied’ adviser sells products from a defined set of institutions.

Similar to the KIID in Europe, changes have been made to the ADV part II form which sets out the minimum requirements for the brochure investment adviser firms are required to provide to clients and prospective clients. In the future, this will need to be in the form of a 'plain English' narrative, rather than the existing 'check-box' format. It will have to be given to investors at both the time of investment and annually thereafter. There is also a renewed focus on due diligence which is changing the shape of the industry following the scandals during the crisis (e.g. Madoff). However, in contrast to the EU position, there is little focus in the US on the issue of commission payments to intermediaries.

ASPAC

The ASPAC region is very diverse, many jurisdictions already had specific disclosure requirements in place prior to the crisis, but some have been strengthening these more recently. Japan's FIEL has already addressed some of the distribution issues other regulators are considering now, and though the disclosure requirements contain similar information to that outlined in the KIID, unlike PRIIPs FIEL's aim is not to provide comparability across different product categories – this is an area where additional regulation may be introduced. The shape of regulations will very much depend on the regulatory evolution in Europe.

In China, there have recently been signs of a further opening of the country's funds distribution market to overseas financial institutions. The Chinese government announced during the May 2011 Sino-US Strategic and Economic Dialogue meetings that foreign banks incorporated in China would, for the first time, be allowed to distribute mutual funds and act as fund

custodians. The exact timetable for these changes in regulations, and the approval process banks will need to go through to obtain the necessary license has not yet been announced. The fact that only Reminbi-denominated funds registered for sale in China, manufactured by domestic Chinese or joint-venture fund houses, are permitted to be distributed will limit the impact of this change in regulations on the global fund management community.

The Hong Kong regulator introduced its version of the European Union's KIID, the Product Key Fact Statements (KFS) before the KIID was finalized. Similarly in India the Securities and Exchange Board of India (SEBI) requires asset managers to maintain a copy of full investor documentation including Know Your Customer (KYC). There is also a new requirement in Hong Kong that puts the onus on product providers to perform adequate due-diligence to assess the suitability of the selling processes adopted by distributors of investment products. This would include assessing the adequacy of training given to the distributors' sales force and their ability to advise customers on the product. The product distributors in turn will be required to disclose to their customers the monetary or non-monetary benefits they receive in connection with the sale of the product. Whereas in Singapore, the regulator under the Financial Advisers Act requires distributors and financial advisers to carry out a due diligence exercise to ascertain whether any new product is suitable for their targeted clients, before offering the new product to any client. This due diligence exercise will have to be formally approved by management of the financial adviser firm. The financial adviser will have to maintain records of the due diligence exercise and the approval by management.

In respect of commissions, Singapore has gone further than Hong Kong. Rather than just requiring disclosure, the Singapore regulator has introduced limits on fees and charges for retail funds. In Taiwan, recent requirements have been introduced for the disclosure of commissions paid to distribution channels, following the re-focus on investor protection in 2009.

In recent years, SEBI in India has also focused more on investor protection, introducing a number of regulations to empower retail investors in mutual funds. SEBI banned the entry load that was deducted from the invested amount, and following amendments in August 2009, it now allows customers the right to negotiate and decide commissions directly with distributors based on investors' assessment of various factors and related services to be rendered. The objective was to bring about more transparency in commissions and encourage long-term investment.

Though the intent of the amendment was to benefit the investor, it has hit the margins of the asset management companies. Further, higher distributor commission on Unit-Linked Insurance Products (issued by insurance companies) is giving tough competition to the business of mutual funds. In India, the distributors of the mutual fund units are currently unregulated. However, there have been instances of distributors rendering professional advice to investors without the requisite qualifications and information about the mutual fund schemes. Many fall short of giving the desired level of professional advice to investors, which increases the potential mis-selling of the mutual fund products; a more stringent certification program is in development.

The Australian market is being transformed by new reforms that are

banning commissions and requiring advice to be in the client's best interest. Like any change of this magnitude, some organizations are ahead of the curve and are well prepared for the new normal. Others are still finalizing their response and are making some tough decisions about whether to stay in business.

Critics of the Future of Financial Advice (FOFA) reforms in Australia, claim that the reforms don't go far enough in addressing transparency – particularly around conglomerate owned planners who appear to be independent because of differential branding. Others fear that advisers will discriminate towards higher net worth clients, leaving affordable advice beyond the reach of everyday clients.

Platforms

Against this backdrop, the importance of intermediary platforms to distribution has continued to increase and evolve. They now offer a much wider range of products to a broader spectrum of clients. It is also clear that these distribution platforms have commoditized certain products, which has compressed fees and created a higher dependence on technology in order to remain competitive and profitable.

The future

So where will all this new regulation take retail distribution? Unsurprisingly many in the industry argue that there is already a lot of regulation, perhaps too much, and all this change is too much to deal with at once. Unfortunately though, while the regulators and politicians may perhaps agree with that sentiment, consumer protection is the key goal here and a lot of work still has to be done.

As a consequence, in the short term the industry will go through a period of significant change as it adjusts to new regulations – this will most likely cause costs to increase, at least an element of which will be passed on to investors. The ultimate test will be whether the new regulation actually helps and encourages individuals to save and better plan for their future. At the bare minimum, the retirement savings gap must be quickly addressed. But, until the outcome of all this regulation is known, the question remains whether adding more costs and complexity to the distribution of investment products will ultimately help. Fundamentally, in order to achieve the returns they want, investors need to be prepared to accept (and take responsibility for accepting) risk. Helping to educate them to understand this is not just a matter for regulators, but for politicians and the industry alike.

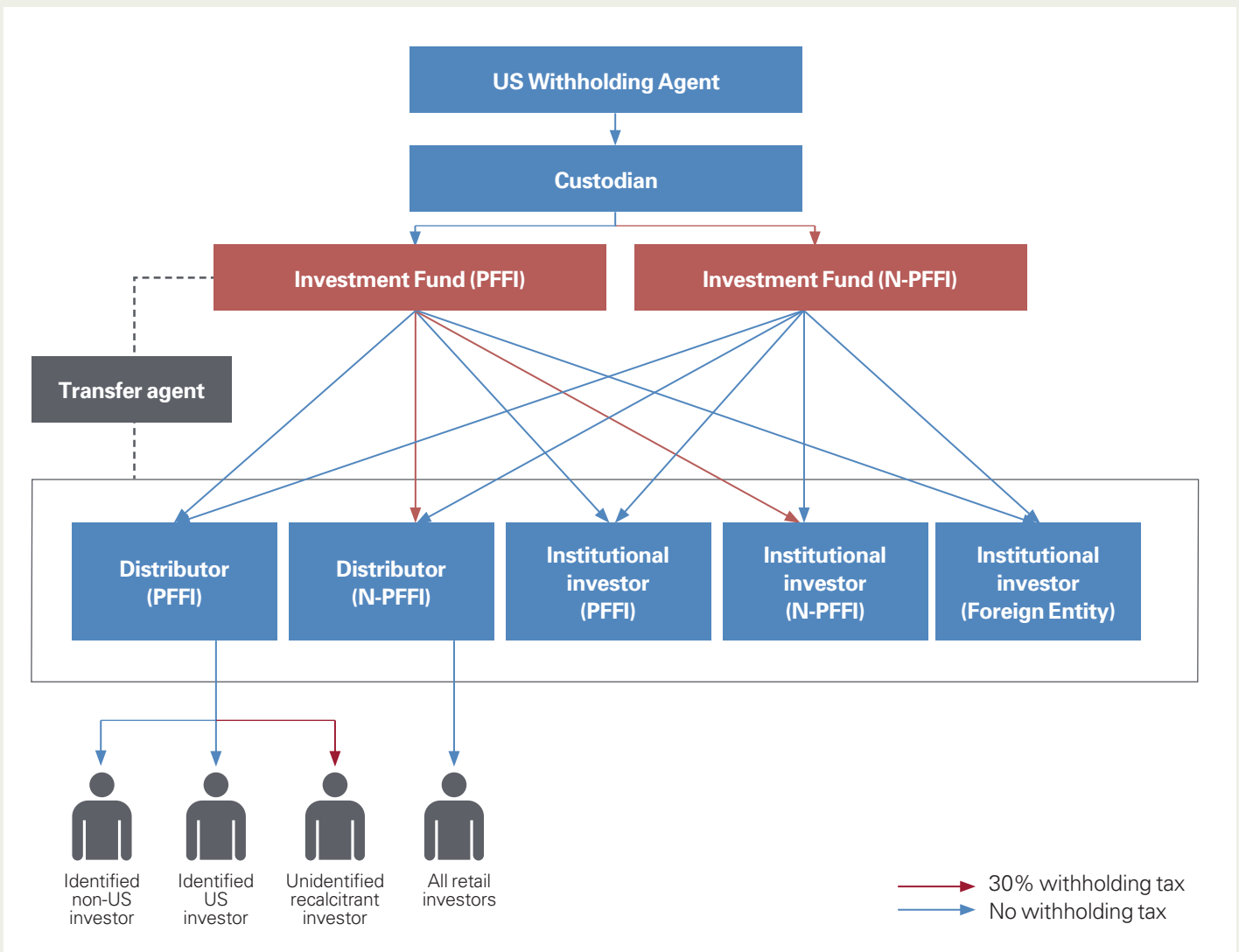
Issues to consider

- Are your data systems and processes capable of addressing requirements under increased due diligence rules around investor information?
- Do you have a framework in place to monitor the regulations developing in each of the jurisdictions in which you operate?
- Have you assessed how your distribution models will change?
- Are your governance and compliance models fit to handle future distribution requirements?
- How will the broadening definition of substitutable products impact your training and recruitment strategies?
- Have you considered how the requirements on commission will impact your distribution model?
- How will the demand for greater transparency impact the way you sell investment products?

FATCA

What does it mean for investment managers and funds?

The implications of the Foreign Account Tax Compliance Act (FATCA) are vast and impact financial institutions as well as many other entities that operate on a global basis. It creates a complex withholding regime designed to penalize foreign financial institutions (FFI) and entities that refuse to disclose the identities of certain US persons.



Source: KPMG International, 2011



The impact of this legislation is felt in a number of areas:

- 1 The initial challenge for firms is the immense task of data cleansing. This will be triggered as organizations are required to go through their existing customer base to identify those it needs to report on, or possibly withhold from;
- 2 The need to build a compliance model which will allow ongoing identification and reporting of US taxpayers who buy products from your organization; and
- 3 The legislation was written for the banking industry – therefore investment managers are grappling with regulations meant for an industry structured very differently; trying to accommodate this through their business model is a huge challenge. This will involve identifying at what point in the distribution chain the legislation applies, designing a compliance model that fits with the business model, and determining whether there are points in the chain which will be significantly more expensive, e.g. access to information, products.

Investment managers have to make strategic choices to address the FATCA legislation, some of these will be about cost, some will be about product mix, and some will be about who their customers are. FATCA compliance requires significant review of the business proposition.

All of these changes are against a background of regulations that have not stopped moving. The majority of the industry has recognized it has to move forward and assume that the majority of regulations are fixed. Otherwise it will never be prepared in time. From our firms' conversations with clients, there are a few exceptions where it may be possible to get concessions from the Internal Revenue Service (IRS), and therefore lobbying continues in these areas. However, it's not feasible to use the lack of uncertainty around regulations as a reason not to start the process. Unlike many regulations in the US and other jurisdictions, FATCA is driven by a statute date, the date is hardcoded: 1 January 2013.

So why should investment managers be concerned?

- FATCA is not just a tax issue. It has fundamental implications for both the business and operating model.
- The complex business model which has developed in the investment management industry is not taken into account under the legislation. Therefore, investment managers now need to pull together the customer side and services of third party providers, to understand what part of the chain will manage the compliance.
- Impact on the firms customer base – Consider the question: How might I need to adapt to continue selling to Americans?

There are two types of compliance models that can be adopted:

- 1 Strict model – This is based on a hard rule of not selling any products to US taxpayers which would minimize reporting requirements.
- 2 Points system – This involves continuous monitoring of all customers and all the elements that could trigger withholding tax to be required.

We believe that the industry will ultimately make some products available to all customers, and some only to non-Americans to minimize the impact on the reporting. This will lead to a higher cost of compliance, lower margins, and ultimately may result in increased product prices.

Despite there being a hard deadline, the IRS appears to have been listening to the concerns of the financial services industry, and many in the industry expect that the IRS will have a light enforcement period initially, with minimal penalties for non-compliance. However, it still means there is lots of work to do now.

For more insight into the implications of FATCA, see KPMG International's recent survey of leading fund promoters, due out in June 2011.

Perspectives: ASPAC

Different priorities

As discussed previously, investment management regulation remains fragmented in Asia, with regulators in the region taking widely different approaches in areas such as funds distribution and product regulation. Some regulators are focused on maintaining the stability of their domestic investment management industries, whereas others have placed more emphasis on attracting overseas investment managers. Unlike Europe, Asia lacks a single coherent regulatory and legal framework to coordinate and oversee such a harmonization of regulatory requirements. This results in a mixed outlook for investment management regulations in the region.

In some countries, the new wave of regulations emanating from Europe and the United States is unlikely to have a significant impact on local laws and regulations already in place. For example, in Japan, due to the comprehensive and wide-reaching regulatory structure that came into effect under the new Financial Instruments and Exchange Act 2007 (FIEL), there are unlikely to be significant changes. Similarly, recent global regulatory developments are also likely to have a more limited impact in China and India, where changes to regulations generally reflect domestic priorities and concerns.

On the other hand, some other countries in the region have seen little significant changes to their regulations for a number of years, and as a result are more likely to feel the impact of the global agenda set from Europe and the US. Australia is a good example, with the last significant changes made in 2002, to the licensing regime in place over fund managers, trustees and custodians. Singapore and Hong Kong are likely to be more affected due to their status as a base for a significant number of hedge funds and other alternative investment managers in the region. Both jurisdictions aim to continue to balance having a robust regulatory regime, with being an attractive location for foreign-backed investment houses seeking to establish operations in the region.

Unlike Europe, Asia lacks a single coherent regulatory and legal framework to coordinate and oversee such a harmonization of regulatory requirements.



Singapore in particular, is an attractive location for start-up investment management companies. Managers with assets under management (AUM) of less than S\$250 million and 30 qualified investors are subject to lighter regulations than those above these thresholds.

The diversity in regulations has an impact on efforts to achieve greater integration for the investment management industry across Asia, and creates significant hurdles in penetrating the countries within the region. There has been much talk in recent years of a pan-Asian funds passport that would allow investment funds authorized in one jurisdiction to be sold to another under a mutual recognition scheme. While some jurisdictions have taken concrete steps in this direction in the form of bilateral arrangements, there are clear challenges in having a UCITS-like passport across a region as diversified as Asia, in the absence of a common legal and regulatory framework and, where individual markets are at different stages of development. In the meantime Asia is not immune to global regulatory developments; further regulatory changes to enhance investor protection may be inevitable, albeit with different priorities and focus depending on the individual national agenda.

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02



Products

Intervention or Innovation?

In addition to an increasing regulatory focus on distribution discussed in Chapter 1, the sector is starting to see investor protection measures taking the form of product regulation. A number of jurisdictions are developing harmonizing frameworks for what were traditionally unregulated products including hedge funds, private equity and real estate. Adviser registration under Dodd-Frank is also having a major impact on both US and foreign investment managers.

Despite differences in regulatory approaches, there are key themes emerging regarding product regulation: bringing products that are currently unregulated into scope; improving investor protection within products already regulated; and giving regulators greater authority to intervene or ban products.

An increased focus on product regulation should help meet the objectives of regulators and politicians, particularly around consumer protection but also financial stability and transparency. In its communication dated June 2010, the European Commission (EC) indicated that the future reforms will focus on four principles: enhanced transparency, effective supervision, enhanced financial stability and strengthened responsibility and consumer protection.

The US has already implemented rules to curb short-selling and while the Dodd-

Frank Act does not directly propose product regulation, the requirements for investment adviser registration and Credit Default Swaps (CDS) trading are likely to affect product development.

Regulating the unregulated products

In Europe, the Alternative Investment Fund Managers Directive (AIFMD) brings a broad range of traditionally unregulated or lightly regulated activity into the scope of pan-European regulation. Its remit has been widely set to include hedge funds, private equity and real estate fund managers, as well as essentially any other form of collective that is not a Undertakings for Collective Investments in Transferable Securities (UCITS). Although it is the Manager (the AIFM) not the Fund (the AIF) that will be regulated, the Directive as drafted will impact a number of areas in respect of funds that are targeted at institutional or professional investors. While AIFMD's aims are to improve transparency and consistency in the way these funds are managed, the requirements on maximum leverage amounts and risk management are likely to have a significant impact on ultimate product design. The AIFMD, discussed in detail in Chapter 4 ([Alternative Investments](#)), also brings with it greater responsibilities for depositaries that are expected to also be extended across all UCITS funds. Increasing depositary (custodian) liability to include any loss within the fund unless it can satisfy the burden of proof that the depositary was not at fault, is a key area of ongoing contention. This measure is directly aimed at mitigating any future Madoff-type incidents.

In the US, Dodd-Frank and the corollary laws that have been adopted globally are having a similar impact as the AIFMD in Europe. The new rules (that are in various stages of being adopted) impact most significantly on alternative

investment managers, predominantly because many, particularly the large managers, are now required to register as investment advisers with the SEC by Q1 2012, as discussed in the [Americas Perspective](#). This is a vast change for these managers, who have to date taken advantage of certain registration exemptions. As with most of the rules under Dodd-Frank, adviser registration will have a significant impact on foreign investment managers and funds with interests in the US⁴. Another significant change to products in the US has been on regulating CDSs, this is discussed further in Chapter 5 ([Capital Markets](#)).

Improving investor protection

Back in Europe there are examples of regulators wanting to improve protection and reduce risk for investors. These include:

- revisions to the Deposit Guarantee Scheme Directive to include further harmonization of the rules with a view to ensuring effective protection for depositors throughout Europe;
- revisions to the investor compensation scheme to enhance the protection of UCITS investors who are currently excluded from the benefits of the scheme, where losses are incurred due to the failure of a UCITS depositary or sub-custodian;
- UCITS IV: is in the final stages of implementation and among other changes, there are enhanced risk management requirements which are in part, a response to the emerging trend of increasingly sophisticated hedge fund type UCITS investment strategies in funds fundamentally designed for the mass retail market;
- UCITS V: in response to losses in UCITS funds from the Madoff fraud and Lehman Brothers default, the EC has reviewed the UCITS framework and plans to further harmonize

and strengthen requirements for depositaries to ensure a high level of consumer protection; and

- EC Communication on Packaged Retail Investment Products (PRIIPs). This provides a clear commitment to further regulate and enhance the sales process of relevant retail investment products.

Outside Europe, in Singapore, there have recently been big changes to the regulation of fund managers. In particular regulations for so-called 'exempt fund managers' (managers with not more than 30 qualified investors) are being tightened.

Banning of products

In the EU, the proposed updates to MiFID include giving authority to national regulators and the new European Securities and Markets Authority (ESMA) to step in and ban products in order to control systemic risk. Specifically, in the UK the Financial Services Authority (FSA) has also said it will be more interventionist and look to intervene in product development including banning products to improve investor protection⁵. Although some may be in favor of such interventionist regulation others have pointed out that the mis-selling problems of the past were caused by unsuitable advice rather than because the products themselves were fundamentally flawed.

4. *Dodd-Frank for Foreign Investment Managers: Is it really significant?*, KPMG International, May 2011.

5. FSA Discussion Paper (DP) 11/1 "Product Intervention", January 2011.

Elsewhere, Japan does not have an outright ban on any product class, although there are limits on possible investments by institutional investors and guidelines for product design and development. For example public pension funds such as the Government Pension Investment Fund (GPIF) and mutual pension funds are prohibited from investing in alternative products; publicly offered investment trusts are allowed to only purchase securitized products which have a market value and are sufficiently liquid, and industry bodies have issued guidelines on limits for derivatives and leverage.

Unfortunately many questions are being asked about the new paradigm shift but there are very few answers. Will regulation stifle innovation? Will costs to investors significantly increase? Will investors' confidence return? Ultimately, these regulations will likely improve investor protection – and if that is achieved at a sensible price, and if it encourages people around the world to save more – that must be a good thing. History suggests however that investors' losses will occur again and there will be further change to come.

Issues to consider

- Are you aware which product regulatory regimes are relevant and appropriate for your business?
- Do you know what is involved to comply with the requirements of the relevant regimes?
- Have you undertaken a strategic review to determine the optimal place for various parts of your business to be based (i.e. based on the various requirements of UCITS/AIFMD in Europe or Dodd-Frank in the US)?
- Have you undertaken a detailed impact assessment and gap analysis to determine what needs to be done to comply with the relevant regulations?
- What impact will increased requirements, such as adviser registration, have on product development?
- How will your product mix change if regulators are given more interventionist powers? Will this change the products/market you are able to operate in?
- How will you determine which customers a product is likely to be suitable for, how the design, description and distribution channels, for that particular product are likely to ensure that the product reaches its intended customers, and that is not mis-sold to customers for whom it is unlikely to be suitable?
- If you were previously in a less regulated sector (hedge funds, private equity, real estate, etc), do you understand the scale of change that is required for your business?
- Do you have the infrastructure to be able to respond to the burden of proof required for depositaries?
- How much will change cost and how can you remain competitive?

Perspectives: Europe

Compliance or opportunity?



UCITS is a major focus for all European fund managers in 2011. The pan-European regulatory framework governs retail funds in the EU, first passed in 1985 – the latest set of revisions, UCITS IV is effective from 1 July 2011.

As we head to the implementation deadline, virtually all the work that I see going on relates to the mandatory elements and not the optional changes (master/feeder structures, cross-border mergers and management company passport), which are there to generate the efficiencies. Hopefully the focus will move back to these elements later. For now, the hard work fund groups are putting in is on the following:

- 1 Key Investor Information Document (KIID).
- 2 Management company processes: the UCITS IV Directive brings requirements for much greater robustness, particularly around risk management within management companies.
- 3 Risk management for funds: new guidelines have tightened in a number of areas: calculation of global exposure, calculation and disclosure of leverage, liquidity risk policies etc.

It would be a real missed opportunity though, if the efficiency measures in the Directive don't lead to some structural changes and reduction of cost. I really hope to see fund managers taking advantage of the opportunities presented rather than just implementing the mandatory requirements of UCITS IV.

One obstacle stands in the middle of the path to creating a single European market through UCITS and that is taxation. Further work is needed to ensure that cross-border funds are successful and competitive. Taxation issues need to be addressed in regards to fund mergers, passporting and VAT.

In the meantime a further review of the legislation covering the issue of depositary duties and liabilities, started its consultation process in 2010. The intention of UCITS V is to enhance investor protection but it will be important that this does not end in a general rise in both operating costs and depositary fees that would negatively impact investor returns.

The UCITS regime has been very successful in setting a regulatory standard for retail funds. The recent use of a derivation of the word UCITS (Newcits), is used to describe UCITS funds adopting hedge fund strategies, can only cause confusion among retail investors and could potentially damage the strong and trusted international brand that UCITS has become.

Away from UCITS IV, focus is on raising the bar on governance and the overall risk and control framework. Good fund managers realize the importance of the fiduciary responsibilities that they have been given by their clients and they believe they need to take these very seriously. With all the other regulatory initiatives investment managers need to address, clearly the next couple of years will be a very busy time for them, as well as the regulators.

It would be a real missed opportunity though, if the efficiency measures in the directive don't lead to some structural changes and reduction of cost.



Tom Brown
Head of Investment Management,
KPMG's EMA region

03



Governance, Risk and Fiduciary Responsibility

Better, safer performance

Shareholders, other stakeholders and regulators are increasingly demanding greater transparency and accountability from investment managers. While there is much to be gained from this in rebuilding investor trust, it also requires detailed reviews and enhancements to existing governance frameworks as well as increased proactive engagement with shareholders.

Investment managers need to address different aspects of governance: one being around the traditional governance framework as exists in banks and other institutions, the second being how the investment firm determines its investment strategy, and how it seeks to improve the performance of the companies it invests in, which is referred to as fiduciary responsibility. Both of these are intrinsically linked.

One of the core corporate governance challenges in relation to the large modern corporation, especially in financial services, is resolving the *principal-agent*⁶ problem and managing the conflicts of interest that invariably arise. The danger from conflicting motivations is compounded by the asymmetry of information between the parties involved; where the agent (such as a fund manager) is naturally much closer than the investor to information about the actual performance and risks of the investment. In the wake of the crisis, Alan Greenspan the former chairman of the Federal Reserve, summed up the issues in his testimony to a US Congressional Committee:

“I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and their equity in the firms.”

The prevailing view is that better alignment of the interests of principal and agent, of investment manager and shareholders and other stakeholders, would lead to better governance and a more stable financial system. Problems related to short-term thinking may be reduced; the risks of moral hazard (gambling with other people’s money) may be minimized; and compensation would likely be more closely linked to long-term performance. In aligning those

interests, the key question, then, is ‘How can investors be encouraged to behave more like owners?’

The truth is that the scope is limited. Periodically, shareholder pressure groups make the news for voting against an investee’s remuneration report. But such actions are rare and mostly driven by propaganda. In financial services, especially, the very liquidity of the market forces against long-term shareholder engagement. The problem is further exacerbated in investment management where the large shareholders, such as pension funds, are themselves simply agents for a different underlying group of principals – the individual savers.

US

One of the main components of Dodd-Frank is the investment adviser registration requirement which carries a number of obligations for firms to examine, and in many cases enhance, governance and fiduciary responsibility within their organizations. Specifically, investment advisers are required to implement a governance model and to identify an appropriately qualified and experienced Chief Compliance Officer (CCO) with sufficient standing to oversee the firm’s adoption of a compliance program and monitor its regulated activities.

Proxy voting

Among other shareholder reforms, the proxy voting requirements have been changed following the financial crisis to address the Securities and Exchange Commission (SEC)’s concerns about:

- the potential for over/under voting;
- the inability to confirm votes;
- proxy voting by institutional voters; and
- the equitable distribution of fees associated with the solicitation of proxy votes.

As a result, firms are now required to restrict access to company proxy materials. The new requirements apply to managers exercising discretion over certain securities that have an aggregate fair market value of at least US\$100 million on the last trading day in any of the preceding 12 months. The SEC is also requiring institutional investment managers subject to the Exchange Act’s proxy voting requirement, to include a separate resolution in its proxy statements asking shareholders to approve compensation for certain specified executives.

Custody rule

The SEC is adopting amendments to the custody rule under the Investment Advisers Act of 1940. The amendments modernize the rule to current custodial practices and requires advisers that have custody of client funds or securities to maintain those assets with broker-dealers, banks, or other qualified custodians. The amended rule also provides a definition of ‘custody’ and illustrates circumstances under which an adviser has custody of client funds or securities.

The amendments are designed to enhance protection of client assets while reducing burdens on advisers that have custody of client assets, but they are having unexpected impacts on in-house pensions investment advisers. Many companies who have established in-house investment advisers are now finding that they are caught by the new rules. Managing the consequences is proving onerous in a number of cases.

For example, real estate fund managers that have previously had custody of the assets are relying on the

6. This is where an owner or investor (the principal) sub-contracts the management of his capital to a third party (the agent).

private fund exemption, which requires that the financial statement audits are sent to clients within 120 days of completion. In some instances, these managers rely on this exemption for only a percentage of the funds that are being advised, thus the manager must implement procedures to comply with the custody rule, which among other requirements a surprise audit is needed.

Europe

In the EU, the Commission has released a Green Paper that launched a public consultation on possible ways forward to improve existing corporate governance mechanisms, addressing boards, shareholders and implementing the comply-or-explain principle⁷. The European Parliament's Committee on Economic and Monetary Affairs has recently responded to this by publishing its recommendations setting out its thinking ahead of more formal proposals.

In addition, the European Fund and Asset Management Association (EFAMA)⁸ recently unveiled a code of best practice in corporate governance. This aims to promote engagement between investment management firms and investee companies, and contains guidance on key areas including: company strategy, performance, board construction, remuneration and corporate social responsibility. Managers are encouraged to adopt the voluntary code and make public disclosures concerning their compliance with the code – either in their annual reports or on their websites.

Specifically in the UK:

- in 2010 the Financial Reporting Council published a new Stewardship Code for institutional asset managers of pension funds, insurance companies, investment trusts and other collective investment vehicles. This aims to

'enhance the quality of engagement between institutional investors and companies to help improve long-term returns to shareholders and the efficient exercise of governance responsibilities';

- there has been an increasing trend in the focus of the Financial Services Authority (FSA) on governance and risk management. Many firms are being required to seek expert assistance in improving terms of reference and reporting lines and making organization changes to ensure senior management, and the board, have sufficient strength and experience to properly oversee risk management.

ASPAC

In Japan, pension funds (as the most significant institutional investors) have actively promoted investee company governance. Their active leadership in this area is because Japanese stocks (which form a major asset class in the fund portfolios) have been largely stagnant over the past decade. In addition, the common practice to cross-hold each others' stocks led to corporate governance issues. In order to re-focus management effort on the investor, the funds have adopted guidelines on proxy voting, requiring investment managers to closely monitor the voting policies and actual votes of trust banks and life insurers in order to indirectly influence the corporate governance at the investee. Although the guidelines are adopted at the self-regulating industry body level and by the individual funds, they are considered to form a part of the fiduciary responsibility framework.

In India, the Securities and Exchange Board of India (SEBI) set up the 'Committee on Review of Eligibility Norms' (CORE) to re-visit the eligibility norms and other functional aspects prescribed for various intermediaries. Key recommendations relate to an

Many companies who have established in-house investment advisers are now finding that they are caught by the new rules. Managing the consequences is proving onerous in a number of cases.



increase in the minimum net worth of asset management companies⁹, change in the definition of net worth, a sponsor to be a regulated entity, and change in definition of control. The objectives of the proposed recommendations are to allow only the serious players to enter and remain in the market. The proposed changes are likely to lead to a better governance of the mutual fund players, thereby boosting investor confidence in the industry.

Elsewhere in Asia, there are rules in place governing the outsourcing of functions by investment managers, as many managers outsource key functions such as fund administration, accounting and custody of assets. Shareholder activism is still in its infancy compared to the US and European markets, and its development is not helped by the fact that a large number of Asian listed companies are closely held.¹⁰

Hedge funds

Hedge funds have traditionally been lightly regulated or self-regulated. In the wake of the financial crisis, a number of leading policy makers questioned the potential for the activities of hedge funds to increase systemic risk. Although there were strong arguments in its defence, the sector responded by establishing the Hedge Fund Standards Board (HFSB) to promote industry best practice through transparency, integrity and good governance. The aim being to reassure investors, maintain a high reputation for the industry, facilitate investor due diligence and minimize the need for restrictive regulation.

New governance structures

Given the clear corporate governance theme emerging across global regulation, all in the investment management sector should now be taking a hard look at their governance structures and reviewing the management of their business, as well as their management of investor money. Putting in place improved arrangements for risk management, analysis and oversight may carry additional costs, but as economies revive and the sector returns to growth such measures will be increasingly necessary.

In the wake of the financial crisis, a number of leading policymakers questioned the potential for the activities of hedge funds to increase systemic risk.

Issues to consider

- Does your board and senior management have responsibility and accountability for strategy, risk appetite and internal control frameworks?
- What is the role of the board and senior management in determining how the firm should meet the broad thrust of new regulatory requirements?
- How will the increased focus on liquidity and risk management impact your firm?
- How will you organize your business to meet these fiduciary responsibilities?

7. The EU corporate governance framework, COM (2011) 164, Brussels 2011.

8. With input from EFAMA members from 20 European countries.

9. From the existing INR 100 million to INR 500 million (1 USD = INR 45).

10. A firm whose issued share capital is mostly held by a family or small group of individuals.



04

Alternative Investments

A healthier industry

The crisis forced regulators globally to re-consider the regulation and governance of the alternative investments industry. While it is generally accepted by the industry that hedge funds did not cause the crisis – this is not the view of regulators, governments and politicians particularly in the US and Europe where hedge funds and their activities have become a key focus over the last two years. Proposed regulations in Europe and the US for hedge fund managers are reaching workable solutions, but will also bring additional sectors into scope. In particular, real estate and private equity firms will also be heavily impacted and will need to make major changes to their models. As a result many firms may be considering moving their operations offshore to avoid the increased regulatory burden – this is an area to watch. In particular, will the alternatives industry split into onshore, management segments while the more specialist sectors remain or move offshore? And what impact will remuneration regulation have on this sector?

In comparison, the regulatory response in the Asian and Australian markets has been more limited with the focus on ensuring regulation is appropriate and proportionate. This difference in approach is perhaps because they were less affected by the crisis.

Alternative Investment Fund Managers Directive

In November 2010 the European Parliament approved the Alternative Investment Fund Managers Directive (AIFMD), which brings non-UCITS (Undertaking for Collective Investments in Transferable Securities) collective investments, for example hedge funds, private equity and real estate into regulatory scope¹¹. The aims of the Directive are to improve transparency and consistency to the way these funds are managed and operated, which is intended to improve the overall stability of the financial system¹².

While many in the sector argue that these new regulations are disproportionate to organizations that carried little responsibility for the financial crisis, the reality is that political and regulatory aims will mean change is now inevitable. With the Directive approved, attention has shifted to the consultation on 'Level 2' measures, where sector-specific committees and regulators advise on technical details. The Directive is expected to be transposed into national law and implemented in Member States during mid 2013, although this is subject to confirmation due to delays in finalizing and translating the Level 1 Directive text. The European Securities and Markets Authority (ESMA) has established a number of subgroups that are working with the industry and the Alternative Investment Management Association (AIMA) to discuss and draft the Level 2 details; hopefully the lead role taken by the industry will result in workable rules.

According to AIFMD, hedge fund managers will have to appoint a depository. The level of depository responsibility and liability is one of the most controversial aspects of the Directive and this is still being debated as part of Level 2. The outcome of this

debate will likely play a key role in the decision of whether to base the fund onshore or offshore.

Development of AIFMD Level 2 proposals

There are currently four taskforces researching the key points of the legislation:

- France – The Aurtorité des Marchés Financiers (AMF) is considering the relationship between appointed depositories and AIFMs. This includes the custody obligation in relation to collateral. Custodians could be left with unlimited liability relating to some of their holdings;
- Ireland – The Central Bank of Ireland is developing a method for categorizing hedge fund types. Its findings may lead to re-registering under the UCITS regulation, which allows a number of investment strategies currently employed by hedge funds;
- Germany – Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) is working on the structure of funds and also what services funds can delegate, and to whom. This may cause serious restructuring for funds with high levels of delegation and also endanger third party administrators outside AIFMD's remit who may be banned from providing services to firms within the Directive's scope; and
- UK – The Financial Services Authority (FSA) is covering leverage, transparency and risk management and the disclosure of these key indicators to investors. Leverage calculation is a highly subjective area as fund managers will argue that use of derivative-based hedging strategies should be taken into account and be allowed to offset the overall leverage calculation. It is abundantly clear that a one-size fits all approach will not

be effective in accurately calculating leverage, or giving a realistic account of the risk for some of the more esoteric fund strategies.

The taskforces are expected to report their findings in November 2011 on the road to actual implementation in 2013. In addition, remuneration and capital requirements will also have a material impact on fund managers.

Response

When new regulation is under development, judging the right time to start preparing for it and how much effort to devote to anticipating the eventual detail that will follow, can be difficult. In this case, the broad impact of the Directive is clear and, given the short timescales involved (complete Level 2 guidance is expected at the end of 2011), fund managers should begin to prepare now. In most cases firms already know whether they will fall under the scope of the Directive. In a few cases at the margin, some changes to the structure of the business model may swing the decision one way or another. These firms should be undertaking a detailed review of their business strategies now. For the remainder, guidance on the bulk of the regulatory requirements can be deduced from UCITS and Markets in Financial Instruments Directive (MiFID) fund managers.

11. The funds in scope are defined as all funds that are not regulated under the UCITS Directives on collective investment schemes in the EU – accounting for around €2 trillion in assets – European Commission, Explanatory Memorandum, Proposal for a Directive on Alternative Investment Managers, 30 April 2009.

12. According to a recent KPMG International survey of European investment managers.

In the short term, while the Directive drafting continues regulators will call for details of products, markets, consumers and operations and will require documentation of key controls, processes and policies. All of this information can be prepared, reviewed and rationalized over the coming months – this exercise should carry spin-off benefits for operational efficiency and clarity, even if in some cases additional costs and complexity may result.

In some cases, the new regulations on depositary liability will require clarification of the legal ownership of assets, with corresponding changes to documentation and responsibilities.

A key focus of the regulations will be the internal framework for risk management and liquidity management. This could be a culture shock – especially for those private equity and real estate funds that have not had comparable experience under UCITS. In all cases, the Directive will impose a structure of discipline and rigor which the far-sighted firms should welcome.

AIFMD is wide reaching and, as it stands, is likely to have significant unintended consequences. Fund managers may be incentivized to move to other global financial centers and both smaller and start-up funds, traditionally a major source of innovation, may be forced to shut as the cost of the regulatory burden increases. This may also advance the recent trend towards consolidation in the industry. Other groups at risk include those providing custodian services for assets. With the potential for unlimited liability, firms will likely either raise the fee that they charge or stop providing custody services altogether, causing a reduction of choice and another system-endangering concentration of assets on the balance sheet of several institutions.

Less change in ASPAC

Previously, alternative investments have not been particularly active in Japan. Therefore as a result of the crisis there has been minimal change in the regulation of this sector. 'Hedge funds' as such are not defined under Japanese law. However, if the hedge fund meets certain criteria set out by Financial Instruments and Exchange Acts (FIEL) for a 'financial instrument operator', then they will be required to register, and the hedge fund will be subject to FIEL. Alternative investments have recently been gaining popularity among private pension funds as a means of boosting their conservative portfolios. In particular, hedge funds have a relatively strong following according to a 2009 survey, showing they made up to five percent of asset allocation on average.¹³

Although alternative investments are not regulated according to product class, some investors follow industry practices such as mentioned in Chapter 2 ([Products](#)) which will not allow them to hold large concentrations of alternative investments, or design products with significant concentrations of alternative assets, creating a de-facto industry 'limit' on alternative investments.

In both Hong Kong and Singapore, the pool of investors who may invest in alternative investment products, including hedge funds and private equity funds, is effectively limited by regulations that prevent funds with such underlying assets obtaining authorized or unrestricted fund status. Investors to these 'unauthorized/restricted funds' must meet minimum net wealth thresholds of US\$1 million in Hong Kong, and net personal asset of S\$2 million or income of not less than S\$300,000 in the preceding year for Singapore. In Taiwan, the regulations are more rigid allowing investment funds to only invest in types of investments

prescribed by the regulator, including listed equities; securities traded on the over-the-counter market; government bonds; or publicly offered and issued corporate bonds and financial bonds.

US changes

In the US, there are also significant changes in the regulation of the alternative investment management industry. However, much of the rule change is not as prescriptive as the European Union (EU) requirements. One of the changes relates to adviser registration (discussed in Chapter 2 [Products](#)). One key area of focus for the alternatives sector is systemic risk reporting to the Financial Stability Oversight Committee (FSOC) via Form PF, which will require all private advisers to report assets under management and other fund-specific data for each private fund, including:

- gross and net asset value;
- monthly and quarterly performance data;
- total borrowings, along with a breakdown of borrowings among domestic and international financial institutions and non-financial institutions;
- identities of creditors that the fund owes at least five percent of the funds value;
- total number of beneficial owners; and
- percentage of ownership of the five beneficial owners having the largest equity interest.

Large private advisers (which will be determined by the type of fund advised) will have additional reporting requirements, including:

- information about fund borrowings and guarantees;
- information about debt of controlled portfolio companies (including debt-to-equity ratios and debt maturity profiles);

- identity of persons providing bridge financing to portfolio companies and the amount of such financing;
- additional information regarding financial industry portfolio companies;
- information on events of default on any fund debt or portfolio company debt during the reporting period; and
- a breakdown of the fund's investments by industry and geography.

Remuneration

Remuneration is a hot topic following the crisis; political pressure has led to increasing regulation in line with the new focus on risk management. The Capital Requirements Directive 3 (CRD3) in Europe has led the UK FSA to implement a more prescriptive regime for certain financial services businesses. The key effects on staff affected by the Remuneration Code as a Tier 1 firm (most banks) include:

- 40 percent of any bonus payments must be deferred for three years, and this rises to 60 percent when the bonus is greater than £500,000;
- at least 50 percent of any variable remuneration must be paid in shares, share-linked instruments or other non-cash methods;
- guaranteed bonuses may only be given to new hires in the first year of service;
- firms must ensure that their total variable remuneration package does not limit their ability to strengthen their capital base;
- severance payments are required to reflect performance over time and must not be seen as rewarding poor performance or failure; and
- pension benefits are required to be held for five years in shares or share-like instruments.

The concern for hedge fund managers in the UK remains however, that the requirements under the AIFMD for remuneration may not take a similar proportionate approach to that taken by the FSA. If proportionality is not taken into account, this could be one of the greatest challenges for AIFMs going forward.

What is the future for alternatives?

All this change means a period of hard work as industry constituents seek to respond and then comply with new regulations. In the medium to long term a more healthy and more mature alternatives industry should emerge, meaning better management of systemic risk, the investors and also for the alternatives industry.

Issues to consider

- Have you undertaken a legal entity rationalization program to be able to respond to the new regulations on depositary liability?
- Will your internal risk and liquidity management frameworks be equipped to deal with the increasing regulatory focus?
- Have you re-considered the locations of your business, and where it would be most beneficial to be based?
- Reflecting the G20 emphasis on remuneration, how are you addressing the national differences in requirements?
- How will your ability to offer alternative investment funds change in a more restricted world?
- How will you make the decision on organizing your structure and location to meet demand for these products?
- Will you be able/are you considering whether to offer certain products in part through the UCITS structure?

13. A 2009 survey undertaken by the Japanese by the Pension Fund Association.

Perspectives: Americas

Changes underway, but more to come

Almost a year after its enactment, the passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act will likely result in the most comprehensive overhaul of financial market regulation since the Great Depression. Under Dodd-Frank, US regulatory agencies are required to adopt a total of 386 separate rules primarily affecting the investment management industry. The Securities and Exchange Commission (SEC) alone must adopt 95 of these rules. Dodd-Frank also mandates 16 separate studies of financial markets, with five of these studies to be recurring. Although Dodd-Frank's scope is significant, the legislation marks only the beginning of a broader regulatory sea of change that will transform the investment management industry in coming years.

Some changes are underway. Under Dodd-Frank, most alternative investment managers are required to register with the SEC by 21 July 2011. However, the deadline is likely to be delayed until the first quarter of 2012. As part of the registration process, these new registrants will be required to identify a Chief Compliance Officer (CCO), develop and implement a governance and compliance program, and will be subject to periodic inspection by the SEC's examination staff. Other changes bearing on asset managers include enhanced disclosure requirements for filings made on Form ADV Part 2, an investment adviser disclosure document which has evolved from a 'check the box' format to a narrative document with expanded information requirements. Another notable change concerns new reporting requirements for monitoring

systemic risks required under Form PF (Chapter 4 [Alternative Investments](#)). The new Form PF filing will require investment managers to report various attributes of their portfolio holdings on a periodic basis. Other changes indirectly affecting asset managers include changes to regulation of over-the-counter (OTC) derivatives and potential changes to industry fiduciary standards (Chapter 1 [Retail Distribution](#)). Lastly, Dodd-Frank aside, other regulatory changes bearing on investment managers are in the works, including a new custody rule, 'pay-to-play' restrictions, Reg. SHO concerning short-selling, and new proxy voting rules and disclosures, all of which are discussed in this report.

These regulatory changes may be a catalyst to accelerate certain trends that have been underway within the industry. Specifically, product convergence among asset classes that traditionally have remained separate and distinct, may accelerate now that the SEC registration requirement no longer serves as a barrier to entry (see [Products](#)). We have seen some private equity fund managers starting to offer hedge fund products to their investors and some mutual fund complexes contemplating moves into the alternative segment by offering hedge funds and similar products. Other trends that continue are the consolidation of asset managers, fee compression, and managers' movement to open architecture models.

Technology and greater transparency have caused the investment management industry to become more global in terms of strategies and

Although this global business approach has led to opportunity and growth, it remains uncertain whether global regulatory coordination will continue to lag, and potentially impede access to certain regions or countries, due to the competitive disadvantages created by increased regulation.



distribution. Although this global business approach has led to opportunity and growth, it remains uncertain whether global regulatory coordination will continue to lag, and potentially impede access to certain regions or countries due to the competitive disadvantages created by increased regulation. During the financial crisis, the US and other national regulatory regimes continually voiced that regulatory reform must be a sustained and coordinated global effort. The rationale behind this goal, in part, was to ensure that regulation did not create a competitive disadvantage for one region versus another. With limited success in coordinating globally, the US and Europe at least, appear to have enacted similar regulatory changes. Whether other regions and countries will follow suit remains unclear.

As firms manage the raft of regulatory change, we should pause to place these changes in context. In the aftermath of the financial crisis, regulators have developed a new set of standards and regulations to protect consumers and the integrity of financial markets. It is critical that firms ensure they are interpreting the intent of the rules based on their individual business models. What we have seen is that the 'new' rules are not completely prescriptive, and often there is scope to build a case, as long as the proper support structure is in place.

Lastly, institutional investors have had a hand in influencing the investment management industry and regulatory change. For example, institutional investors have pushed the industry for increased transparency, enhanced

due diligence processes, and greater risk and management reporting. Institutional investors have also influenced regulatory changes including the 'pay-to-play' restrictions and new custody rule.

Industry pressures together with government-inspired regulatory changes will continue to alter the landscape of the investment management industry for some time to come. We believe that now is the time for investment managers to start change programs that will enable them to remain competitive – even in the face of such dramatic industry change – and find the best fit for their businesses.



John Schneider
US Head of Investment Management
Regulatory practice
KPMG in the US

A view from Offshore

Lord Turner (Chairman of the UK FSA) who undertook a review of the causes of the financial crisis, concluded as long ago as March 2009 that “It is important to recognise that the role of offshore financial centres was not central in the origins of the current crisis... many of the problems arose from the inadequate regulation of the trading activities of banks and operating through onshore legal entities in major financial centres such as London or New York.”¹⁴ Comments such as these however have not prevented the offshore world from being the focus of some intense regulatory pressure in recent years.

This pressure has been driven through various mechanisms, but notable among these has been the third country aspects of the European Union (EU)’s Alternative Investment Fund Managers Directive (AIFMD). These initially threatened to create a barrier to non-EU jurisdictions engaging with EU investors, but also worked to restrict the investment opportunities for those EU investors. The compromise position reached is sensible, retains access to the EU for offshore via several levels of mechanism such as full passport, private placement,

reverse solicitation. According to a recent KPMG International survey, investment managers now believe that the directive will prove largely neutral between EU and non-EU jurisdictions.

The AIFMD along with a plethora of emerging EU directives (see Chapter 4 **Alternative Investments**) will fundamentally increase the cost of investing in the EU as Dodd-Frank and the Foreign Account Tax Compliance Act (FATCA) may do from the US. Offshore jurisdictions will be compelled to adopt some of this regulation, they may elect to adopt other elements and will not need to adopt the remainder. The cost of investing via an offshore product may increase, but by far less than for an onshore product and not at the cost of appropriate regulation. For example, where offshore funds appoint a depositary, it will not need to operate under the punitive liability regime currently being proposed by the EU, but arguably will offer a materially equivalent level of investor protection.

The key offshore jurisdictions already have levels of regulation that suit investors and investor protection equivalent to, or exceeding, some

mainstream EU jurisdictions – with one offshore jurisdiction currently ranking highest globally by the International Monetary Fund (IMF) for compliance with their ‘anti-money laundering/ combating the financing of terrorism’ (AML/CFT) rules. Add to this, increased demand from institutional investors for inflation-beating returns derived from alternate assets in global and emerging markets. The result will likely be an appropriately regulated, cost effective offshore solution for managing the increased flows of capital to the private equity, real estate, infrastructure, natural resources and esoteric asset classes that will drive returns over the next decade.

Neale Jehan
EU AIFMD Working Group Leader
KPMG in Guernsey

14. *The Turner Review: A regulatory response to the global banking crisis*, Financial Services Authority, March 2009.



05

Capital Markets

Indirect impacts

Investment managers will be impacted directly by regulatory changes in terms of increased quantity and quality of capital, and indirectly by their reliance on banks. The degree of direct impact of regulatory change will depend on the degree of balance sheet usage and the sophistication of the investment manager in question.

We believe that a substantial amount of business could move to the asset management, hedge fund and private equity sectors as banks are forced to deleverage and reduce the scope of their activities. Optimal business models will be those that are flexible and able to invest in diversified asset classes and geographies. KPMG firms are already starting to see proprietary trading and securitized products migrating from the banking sector to investment managers. Structuring and trading of exotic derivatives, direct lending and debt restructuring could all follow.

Impacts

The review of the causes of the financial crisis, while primarily focused on the banking sector, also highlighted a number of shortcomings in the wider financial markets. In particular, in the management of securitized products and counterparty credit risk as well as the lack of transparency in over-the-counter (OTC) derivatives markets. With a large proportion of the global OTC market located in Europe, a strong regulatory response is developing among European authorities. In the US, the Dodd-Frank Act will have parallel consequences for OTC clearing and reporting, which will impact on investment managers. Other regulatory initiatives such as Basel 3, although principally directed at banks, will also result in increased regulatory scrutiny and higher costs of capital and costs of trading for investment managers.

During the crisis, OTC markets suffered severe impacts:

- volatile valuations increased net margin positions and severely strained liquidity reserves;
- bid/offer spreads became significantly exaggerated;
- cuts in the size of trading lines lowered liquidity, 'breaking' the market in some products, such that there was no market price available, which as a result meant that liquidation values were difficult to determine; and
- the credit-worthiness of individual institutions deteriorated, leading in some cases to default on payments.

Overall, the lack of transparency regarding OTC derivative positions caused a large drop in investor confidence in the financial sector. In the words of the UK Financial Services Authority (FSA):

These measures were designed to prevent short-selling, including potentially manipulative or abusive short-selling, which was believed to have been a catalyst in the eventual collapse of certain financial institutions that were considered systemically important at the time.

"An acute sensitivity to counterparty risk, particularly at the height of the crisis, had severe implications for financial markets and resulted in the retraction in liquidity as participants became reluctant to trade with each other. This, in turn, was exacerbated by the significant web of interconnections between counterparties, and led to further negative consequences as participants could not properly access financial markets."¹⁵

It concluded that the increased use of central counterparty (CCP) clearing would be a key step towards mitigating this risk. CCP clearing can impose consistent and robust risk management practices, improve market liquidity and efficiency and reduce systemic risk. In parallel, the G20 agreed in 2009 to promote standardization and CCP clearing for credit derivatives, and require that all standardized OTC derivatives should be CCP cleared. Implementation through regulatory authorities and national legislation is expected by the end of 2012. In addition to these core requirements:

- all OTC derivatives must be reported to trade repositories;
- non-centrally cleared contracts will be subject to higher capital requirements; and
- the OTC derivatives market will be monitored to ensure enough is done

regarding transparency, mitigating systemic risk and protecting against market abuse.

In the US, the Dodd-Frank Act contains provisions to achieve these objectives, which will come into effect in mid-2011. Similar measures are being implemented by the European Commission (EC) and European Securities and Markets Authority (ESMA), and other jurisdictions, for example in the Far East, are developing similar regimes.

The impacts are likely to include:

- in the short term, a reduction in liquidity in all products;
- in the medium term, prohibitive capital costs for bespoke credit derivatives;
- structured markets: no significant impact, except potential moves to cash instruments;
- rethinking of the use of Credit Default Swaps (CDS); and
- potential new market entrants, such as asset managers and pension funds, as a result of the more regulated nature of the market and additional security due to standardization of the clearing approach.

One of the more significant product changes that emerged from the financial crisis in the US has been a focus on regulating CDSs. The proposals from the regulators, which include the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC) and insurance, have been to ensure that CDS are required to be traded via an exchange and to offer CDSs the firm will be required to have an insurance license.

Entry barriers are now much higher than in the past and include not only increasing rules on investment products and strategies (e.g. short-selling, derivatives markets rules) but also a potential requirement for managers to

Overall, the lack of transparency regarding OTC derivative positions caused a large drop in investor confidence in the financial sector.

hold more capital, which would make it more expensive to set up a new business in most markets. New managers struggle to raise capital – infrastructure demands are now too great.

To stem systemic risk during the financial crisis, the US regulators continued to focus on short-selling activities and implemented revised rules to curb it. The new rules had an effective date of 10 May 2010 with an implementation date of November 2010. The specific changes included limits that if triggered, imposed a restriction on prices at which securities may be sold. There was an additional requirement for firms to maintain policies and procedures reasonably designed to prevent the execution or display of a short sale order of a covered security at a price that is less than, or equal to, the national best bid if, the price of that security decreases by 10 percent or more from the closing price. The policies and procedures are also required to impose this short sale restriction for the remainder of that day and the following day. These measures were designed to prevent short-selling, including potentially manipulative or abusive short-selling, which was believed to have been a catalyst in the eventual collapse of certain financial institutions that were considered systemically important at the time.

While the SEC's focus on insider trading is not new, the methods that are being employed by the SEC to identify evidence in cases involving insider trading have changed significantly.

Specifically, the prosecution used wiretaps, which had been mainly reserved for organized-crime, drug and terrorist cases. In the Galleon case, the prosecution featured 45 wiretaps showing how Mr. Rajaratnam gained access to highly sensitive information that resulted in an estimated US\$63.8 million in illegal profits. This case and other current investigations are changing the landscape for enforcement cases and will likely have an impact on the industry requirements for controlling insider information.

In Japan, to protect the fairness and transparency of transactions, as well as ensure investor protection and maintain trust in the markets, the Financial Instrument and Exchange Act (FIEL) is designed to comprehensively regulate unfair trading, dissemination of false and misleading information, market manipulation, and insider dealing, all of which are subject to criminal charges. After the financial crisis, reported instances of delayed and failed securities and derivative trades in addition to a lack of a central clearing organization, particularly for OTC derivatives were seen as significantly damaging to market operations and led to a revision of the FIEL, which established trade data saving and reporting requirements, and mandatory use of a clearing organization for OTCs.

The Japanese Financial Services Agency (FSA) has been outspoken in its views against short-selling. FIEL established permanent regulation over short-selling, and gave the FSA the power to monitor the matter closely by requiring a trading entity to disclose and report information about trades that potentially fit the profile of a short sale.

Additionally, the FSA has adopted temporary measures including a total ban on naked short-selling immediately after the financial crisis, and compulsory

reporting and disclosure of short positions which, in principle, equal or exceed 0.25 percent of the total outstanding stock for all hedge funds. These measures are expected to remain in place until 31 October 2011. Some of the recent changes in India include:

- transferability of mutual fund units: from August 2010 all fund houses can facilitate a smoother shift of mutual fund units between two demat accounts;¹⁵
- permission to trade: recently, the Securities and Exchange Board of India (SEBI) has permitted trading of mutual fund units on recognized stock exchanges, enabling the investor to know about the validity of his order and the value at which the units would get credited/redeemed to his account by the end of the day; and
- additional mode of payment through Applications Supported by Blocked Amount (ASBA) in mutual funds. Besides cash/cheque payments, mutual funds/asset management companies provide ASBA facility to investors for all new fund offers launched on or after 1 October 2010. This system has two advantages: (i) money which is required for the allotment of shares is taken from the bank account only when the basis of allotment is finalized and the applicant's application is selected for allotment; and (ii) since the money remains in the bank account of the applicant until the individual is allocated the shares, applicants will now earn interest on cash balances.

¹⁵ *Reforming OTC Derivative Markets: A UK perspective*, Financial Services Authority (FSA), December 2009.

¹⁶ A trading account in India – set up to invest in stock market.

Dodd-Frank Impacts

Hedge Funds and Private Equity

Dodd-Frank has imposed restrictions on investment banks from making and retaining direct investments in hedge and private equity funds. There are certain instances where seed and *de minimis* investments are permissible, but these are subject to specific restrictions, the most significant being that the investment must “not later than one year after the date of establishment of the fund, be reduced... to an amount that is not more than three percent of the total ownership interests of the fund” (subject to a two-year extension), and the investment must be “immaterial to the banking entity” as defined by regulation, and in no case may interests in all such funds exceed three percent of the Tier 1 capital of the banking entity. These restrictions in many cases have resulted in investment banks rethinking their strategies for seed funds that they sponsor and in some instances have resulted in the spin-off of fund product offerings.

KPMG firms are increasingly seeing banks looking to transfer the risk of securitized products to the investment management sector. This is an opportunity for specialist managers who deeply understand the asset class to acquire assets at a discount.

Central Counterparty Clearing

Advantages

- Less mutualization
- Transparency
- Lower capital charge
- Legal and operational efficiency
- Multilateral netting

Disadvantages

- High level of standardization
- Costs
- Competitive advantage lost
- Risk centralization
- Cross product/CCP netting limited

OTC Derivatives

Under Dodd-Frank, the CFTC has been charged with proposing and promulgating rules that will define OTC derivatives as security based swaps or swaps. The underlying goal of Dodd-Frank is to identify any swap that could pose systemic risk based on a variety of factors such as size and lack of transparency. The instruments may be required to be regulated as may the participants in these OTC derivative transactions.

Under the proposed legislation, regulatory agencies will have the ultimate decision regarding the clearing and reporting of OTC derivatives. A proposal by the EC might be less burdensome than Dodd-Frank for the investment management industry, which permits few exceptions. The notable difference from the EU legislation currently is that the Dodd-Frank exception applies only to non-financial entities that enter into certain hedging transactions, while EU non-financial counterparties become subject when their positions exceed a clearing threshold.

Continuing down this same line, Dodd-Frank does not include any exception for uncleared transactions and imposes margin requirements on dealers and major swap participants. The EC’s proposal only requires financial counterparties to have proportionate holding of capital for uncleared transactions or procedures for exchange of collateral.

Cost and operational impacts

The move to CCPs will increase the costs of trading CDS for investment managers. There are also operational considerations in moving from bilateral trading to daily margining, as required by CCPs. In addition, there are also differences in the timelines for CCP clearing in Dodd-Frank and European Market Infrastructure Regulation (EMIR) which could lead to regulatory arbitrage, uncertainty and market volatility. EMIR aims to increase the stability in OTC derivatives markets.

Exotic derivatives and any products in non-standard form will not be able to be centrally cleared and will attract higher capital charges (new market risk and counterparty credit risk charges) for the banks selling them under Basel 2.5 and Basel 3. The impact on investment managers will be increased costs for exotic products and bespoke hedging instruments.

Securitized products

Basel 2.5 (Capital Requirements Directive – CRD3), which is due to be implemented by 31 December 2011, significantly increases Market Risk Capital requirements for banks. There are increased costs for banks holding securitized products, re-securitizations and exotic products. KPMG firms are increasingly seeing banks looking to transfer the risk of securitized products to the investment management sector. This is an opportunity for specialist managers who deeply understand the asset class to acquire assets at a discount. However there is also a risk that investment managers could be attracted to taking on risk they do not fully understand.

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In Hong Kong, plans have been announced by the Hong Kong Exchange to invest HK\$180 million to establish a central clearing house for OTC derivatives transactions by the end of 2012. Interest rate derivatives and non-deliverable forwards will be the first two products handled by the new clearing house. In the future, other OTC derivatives traded in Hong Kong such as equity derivatives will also fall into the scope of this new clearing house. Elsewhere in the region, low trading volumes mean that there has been less focus on this topic than in Europe or the US. For example, the Singapore Exchange has focused instead on implementing a new high frequency trading system.

Capital and Liquidity Requirements

The primary impact of Basel 3 will be to increase the quality and quantity of the capital base of financial institutions, as common equity and retained earnings will become part of Tier 1 capital. It will also have direct and indirect implications for investment managers, for example in relation to tightening constraints on leverage and liquidity and through increased borrowing/funding costs from banks. Similarly, the Australian Prudential Regulation Authority (APRA) has proposed setting minimum capital requirements for fund management entities that are part of a regulated financial services group. The expected timing for this proposal is 2013, although this has not been officially stated. For non-APRA regulated funds management entities, APRA proposes that they be subject to capital requirements of at least 0.25 percent of the funds under management, excluding those balances invested in the life insurance policies or bank deposits of a (regulated) related party.

Issues to consider

- Do you need to review and redesign capital and liquidity frameworks?
- Are you prepared to meet the timescales for the move to central counterparty (CCP) clearing and associated changes to margining?
- Are you prepared for increased regulatory scrutiny and increased reporting requirements?
- Are you well positioned to take advantage of the movement in trading and advisory activities to the investment management sector?
- Do you need to extend the scope of your investment strategies to take advantage of opportunities in the investment management space? Do you need to hire talent from the banking sector?
- Do you have adequate risk management systems and reporting to cover new asset classes and markets?

06



Pensions

Planning to save

Traditionally approaches to pensions have been very nationalistic, with little commonality across jurisdictions. Some countries have mandatory schemes, others voluntary arrangements and some none at all. With ageing populations and governments aiming to protect wealth, retirement planning will likely become a major focus over the next few years. Some pension regulation has prohibited the use of alternatives in the past – this may change which could open up opportunities.

In recent years due to pressures on cost we have also seen the rapid decline in defined benefit pension schemes and concurrent growth in Defined Contribution schemes, adding pressure to individuals for the responsibility of meeting their own retirement financial needs through the passing of risk from the provider to the investor. Evidence suggests investors have not adequately planned or prepared for the practicalities of this.

US

A number of significant developments in the asset management environment have followed changes to pensions regulation, alongside other trends. A major challenge the pensions industry faces is that the range of interests converging on it leads to multiple and overlapping jurisdictions and sets of rules. Major government agencies, including the Department of Labor (DoL), the Securities and Exchange Commission (SEC) and the Internal Revenue Service (IRS), all impose their own regulations. Some recent key developments are summarized below.

Definition of a fiduciary

The DoL is reviewing the definition of a 'fiduciary'. When the Employee Retirement Income Security Act of 1974 (ERISA) was originally introduced, the regulations defining who was acting as a plan fiduciary were drawn very tightly. The DoL note that since the mid-1970s, there have been significant changes in the retirement plan community, with more complex investment products, transactions and services available to plans and individual retirement account (IRA) investors in the financial marketplace. There has also been a shift from defined benefit plans to defined contribution plans – 401(k)-type plans. As a consequence, the DoL believes it is time to re-examine the types of advisory relationships that give rise to fiduciary duties and to update the rigid 1975 regulation so that plan fiduciaries, participants and IRA holders receive the impartiality they expect when they rely on their adviser's expertise.

These changes are likely to widen significantly the range of those caught by the definition of 'fiduciary', and carry major legal and reporting implications, especially for asset management and investment management.

Pay-to-play

In the US pensions context, the term 'Pay-to-play' describes the practice of making campaign contributions and related payments to elected officials in order to influence the awarding of contracts for the management of public pension plan assets. In June 2010, the SEC, in a unanimous vote, approved new Rule 206(4)-5 under the Investment Advisers Act of 1940, designed to eliminate 'pay-to-play' practices. The rule:

- imposes a two year 'time out', with certain exceptions, on receiving compensation for providing investment advisory services to a government client after any one of certain specified persons makes a contribution to certain candidates or elected officials;
- limits the use of placement agents to regulated persons that are subject to either the Rule itself or comparable rules governing political contributions; and
- bans solicitation or 'bundling' of contributions for certain candidates or elected officials.

This rule applies to all investment advisers registered, or required to be registered, with the SEC, and advisers currently exempt from registration under Section 203(b) (3) of the Advisers Act. The rule does not apply to most state-registered advisers and certain other advisers that are exempt from SEC registration. It applies with equal force to direct contractual arrangements between an adviser and a government entity for advisory services and participation by a government entity in an adviser's 'covered investment pools'. This includes private investment funds or registered investment companies that are investment options for government plans.

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Australia

The Australian Federal government initiated a monumental review of Australia's superannuation system (the Cooper Review). Following extensive meetings with industry players and receipt of over 110 formal submissions, the Review Panel released 177 recommendations which primarily focused on:

- enhancing fund governance – a range of measures to codify trustee duties, enhance governance and increase accountability and transparency to members;
- optimizing the 'back office' – an attempt to improve efficiency and deliver savings in administration costs and make the processing of everyday transactions easier, cheaper and faster; and
- improving net returns – through the introduction of MySuper which is a simple, cost-effective product used as a default investment option and requiring funds to participate in annual benchmarking exercises.

Considerable resources have been applied by the superannuation industry in understanding and responding to the Cooper Review. Additionally numerous consultation groups have been established to examine detailed design and implementation issues. With implementation dates in 2011 and beyond, we will be watching to ascertain any significant structural changes and quantify the anticipated efficiency gains.

Japan: Corporate Pensions

Japanese corporate pensions have undergone significant transformation since the introduction of the Defined Contribution Pension Act (DCP) in 2001. Since investment trusts form the majority of products managed under the DCP system, assets have been shifting from corporate pension trusts that managed the defined benefit schemes to asset management firms, by the means of discretionary investment contracts.

After the financial crisis, the financial situation of corporate pension funds managing defined benefit schemes deteriorated. The large earthquake in north-eastern Japan and the subsequent fall in the market are believed to have contributed to as much as an average 0.6 percent drop in the corporate pension funds' operating results for fiscal 2010.¹⁷

The adoption of International Financial Reporting Standards (IFRS) is another issue looming on the horizon for these funds. Voluntary adoption has been allowed from the fiscal year ending after 31 March 2010, and the standards are expected to become a compulsory requirement in 2015. Compulsory adoption may push the pension funds, which form a substantial portion of the asset manager's clients, to recognize reserve shortfalls in their scheme funding immediately. This could force a reconsideration of the funds' own risk tolerance and quite possibly a revision of their portfolios towards more conservative positions. This will be likely to have a knock-on effect on asset managers' profitability, as well as their ability to meet their client's needs for more diverse, yet less risky, products. With much discussion still under way about IFRS, how the industry will react to the final rules remains to be seen.

Japan: Public Pensions

Public pensions in Japan are under pressure owing to the aging population and the difficulty of meeting costs through premiums or tax income. The entity managing the public pension scheme in Japan, the Government Pension Investment Fund (GPIF) will be required to withdraw approximately

6.4 trillion yen (US\$80 billion) from its savings to cover the shortages in fiscal 2011. Although the GPIF will cover this amount by selling some of the Japanese government bonds from its portfolio, the actions of the fund will likely be the subject of much market interest due to their potential impact, including a possible rise in long-term interest rates.

China

"China is still likely to be the first country to grow old before it gets rich."¹⁸ China's population continues to grow, as does India's, and there is a clear challenge for such countries to manage their wealth. Even if the 'one child' policy were to be relaxed, China would still be scrambling to cope with the changing shape of its population. The recent census highlights the urgency of efforts to restructure the economy away from a dependence on growth led by investment and labour-intensive manufacturing for export.

Singapore

The Singapore Central Provident Fund (CPF) has been widely studied by countries seeking to reform their current pension arrangements. It combines significant mandatory contributions (20 percent of salary) with individual investment accounts that allow the employees some control over their investment strategy. It also offers significant opportunities to the investment management sector, with managers, including managers of foreign domiciled funds, able to apply for their funds to be granted 'CPF approved' status.

Hong Kong

Hong Kong also has a mandatory pension system, the Mandatory Provident Fund (MPF), albeit with a much reduced level of contributions compared to Singapore. Until recently, the Hong Kong model allowed employers to choose which investment manager and trustee would manage their employees' retirement savings. The Hong Kong regulator has recently introduced a proposal that allows individual employees to transfer their pension assets from one provider to another, which has resulted in the industry

lowering of fees and expanding their product base.

Taiwan

Other countries in the region operate a less flexible system, including Taiwan, which has in place a mandatory pension plan. The assets are managed under the supervision of the Bank of Taiwan which, in turn, subcontracts the management to asset management companies under contracts that are renewed every two to three years.

Europe

The European Union (EU) Pensions Directive is up for review with a consultation paper issued in March 2011. The European Commission (EC) has asked the European Insurance and Occupational Pensions Authority (EIOPA) to revise the Pensions Directive to require 'consistent' recovery periods across all Member States. While the key concern is whether the EC will impose a Solvency II requirement on final salary schemes, the paper states that submissions should include an assessment of the provision in the Directive which could be extended to occupational Defined Contribution (DC) schemes which are not currently covered. It recognized that DC provision has become much more prevalent in the EU since 2003 and suggests that while the main focus should be on the risks, costs and what happens on retirement are all areas where schemes might require particular attention.

In the UK, the Coalition Government has been very active on pensions since taking office in June 2010, examining state pensions, public and private sector pensions. The general view across most countries in Europe, is that pensions and associated benefits are costing the State far too much and that the burden of provision should shift to individuals and their employers. This is to be achieved through a combination of raising the state retirement age, forcing employers to contribute to a pension scheme for their staff and automatic enrolment as well as cuts to public sector pensions. In addition, the state pension system will likely be simplified with limited means-

tested benefits, so that people are encouraged to save.

In the private sector, the closure of final salary schemes to future accrual and replacement by money purchase has gained momentum, substantially increasing the numbers in DC schemes. The introduction of auto-enrolment in 2012 will result in the number of people saving in such schemes rising dramatically, with an additional five to eight million new pension savers. The numbers of people in the private sector money purchase arrangements, both in named schemes or with individual contracts with insurers, is leading to an increased focus on the risk of products available and the individual members willingness to take investment risk.

The UK's Pensions Regulator is taking an increasing interest on how it should support the DC market in the delivery of good outcomes for savers. Regulators are examining how to raise standards in DC provision covering contributions, investment decisions, administration, protection of assets, value for money and conversion to retirement income.

In the Netherlands, the regulator has intensified supervision of pension funds. Typical concerns include governance of asset and risk management, reporting processes and risk management procedures, and the investment portfolios. For a typical investment manager, the implications involve more intensified reporting on investments and the risks to pension funds. Investment categories which are under very close supervision typically involve private equity, hedge funds and other investments that are hard to evaluate due to the lack of market prices. Funds of funds and pooling structures, which have their own strategic policies are also being closely monitored.

What does this mean for the funds management industry?

Fund managers and insurers already have considerable experience running the unitized funds for DC schemes and offer a wide selection of funds to members. Despite the choice, we believe the vast majority will likely opt for the default funds, often a lifestyle arrangement.

The National Employment Savings Trust (NEST), the scheme set up to take contributions from small employers auto-enrolling their staff, has announced that it is establishing target date funds, and other providers might well find this increases interest in such arrangements.

The active involvement of the UK Pensions Regulator and potential changes to EU legislation in relation to DC governance may mean that trustees and employers take a greater interest in DC administration than has hitherto been the case, leading to greater information requirements and reporting to them and

to the members. This might include producing an AAF 01/06 report or a report produced in accordance with the requirements of ISAE 3402 on activities associated with the administration of DC pension products.

Charges will come under greater scrutiny and possibly greater pressure. Charges have historically been borne by members, and therefore, this may not have been a major issue in the past. However, as governance requirements increase, charges will inevitably be an area of focus.

Issues to consider

- Do you have access to the right information to be able to deal efficiently with the different regulatory frameworks?
- Do you have a framework in place that captures changes in rules and regulations, outside of the major regulatory bodies?
- Is your infrastructure equipped to deal with increasing customer demands on transparency?
- Are you aware of the changing rules around 'fiduciary', and are you prepared to respond?
- How will you develop a better suite of products for de-cumulation during retirement, reflecting greater longevity and wealth among retired persons?

17. Fiscal year ending 31 March 2011.

18. "China's census: Older and wiser?" www.economist.com, 29 April 2011.



07

How will you meet the challenge?

A better strategic fit

The financial services industry is no stranger to regulatory change. Over many decades risk and compliance functions have developed and evolved in response to changes in the regulatory environment. In the main, regulatory change results in additional cost; it impacts business strategies, systems and controls and sometimes resources. Given the current extent of change the most forward-looking companies have already started to invest in their risk and compliance functions and in their IT infrastructure in response to increasingly regulatory complexity. They will also be reviewing their product offerings to consider how they can be made more competitive and profitable.

Change always brings challenge – it also provides opportunities to try new things in new ways. How firms approach the challenges and explore the opportunities will largely dictate their success. How will you meet the challenge?

The regulatory response to the crisis – and particularly pertinent to the investment management sector – has resulted in the extension of regulation into areas of financial services that have traditionally been largely, or completely, outside scope. There is an argument that some of this is driven by politics and populism rather than a genuine need to guard against future instability. Equally, those pushing for further regulation will argue investors need greater protection from risk and the sector needs to take more responsibility for product design and target audience.

Finding the right balance between investor choice and consumer protection is a challenge, and while few would argue that regulation is unnecessary there is a question over whether the many initiatives underway will achieve the desired outcomes. The impact of the changes could have the unintended consequence of reducing investor choice and access to financial services products, create barriers to entry and put greater strain on already weakened economies to bridge the ever widening savings gap.

With all this concurrent change it is perhaps tempting to wait for the precise detail before formulating a response. However, with numerous implementation deadlines looming this may prove to be an irrevocable mistake. The investment management sector can learn useful lessons from its banking and insurance colleagues on the strategy and dealing with wholesale regulatory change. With so many issues in play, firms need to focus on:

- taking account of the totality of regulatory initiatives that specifically affect them and understand the implications, timescales and impacts;
- linking the impact analysis to its commercial model and business strategy to understand how they align and make revisions where necessary;
- assessing the impacts on product design, pricing and distribution model;
- exploring opportunities, for example, diversification, to take advantage of national increasing incomes and wealth; and

Finding the right balance between investor choice and consumer protection is a challenge, and while few would argue that regulation is unnecessary there is a question over whether the many initiatives underway will achieve the desired outcomes.

- working with the flow of regulation towards greater transparency, better product design and appropriateness for intended audience.

These issues can go to the core of the nature of the company. It demonstrates that regulation and compliance can no longer be treated as a secondary issue to that of the day-to-day and long-term running of the business. They should be high on the chief executive's agenda, and issues which non-executives regularly review. This has a number of implications that are as much cultural as organizational:

- the tone, culture and the agenda have to be set from the top: the business as a whole owns the compliance risk issue;
- as a result, the profile of risk and compliance can only rise as new regulation emerges; and
- the enhanced responsibility and visibility which this implies at senior levels requires appropriate governance arrangements and direct reporting lines to the executive and Board members.

Finally, in many investment management companies, addressing these issues will result in major change management. As ever, those who emerge from the regulatory turmoil of the next couple of years with the greatest competitive advantage, will be those who have engaged early and effectively with the challenges – and opportunities – which it will bring.

What does all this mean for you?

- Considering the totality of regulatory initiatives, what actions have you taken to fully understand the implications for your business?
- Have you considered how your strategy and business model need to be revised to deal with all the regulatory initiatives?
- Have you assessed the full impact on product design and pricing and distribution channels?
- How will you work with the flow of regulation towards greater transparency, better product design, and more emphasis on matching products to intended consequences?
- How will you streamline your response to the numerous reform initiatives, avoiding duplication and multiple layers of compliance?

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We would like to acknowledge the contribution of our colleagues from across our global network who helped develop this report:

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Glossary of Terms

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AIF	Alternative Investment Fund	FSA	Financial Services Agency (Japan)
AIFM	Alternative Investment Fund Manager	FSA	Financial Services Authority (UK)
AIFMD	Alternative Investment Fund Managers Directive	FSOC	Financial Stability Oversight Committee
AIMA	Alternative Investment Management Association	GPIF	Government Pension Investment Fund
AMF	Autorité des Marchés Financiers	HFSB	Hedge Fund Standards Board
AML /CFT	Anti-money laundering/ combating the financing of terrorism	IFA	Independent Financial Advisers
ASBA	Applications Supported by Blocked Amount	IFRS	International Financial Reporting Standards
APRA	Australian Prudential Regulation Authority	IMF	International Monetary Fund
AUM	Assets Under Management	IRA	Individual retirement account
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht	IRS	Internal Revenue Service
CCP	Central counterparty clearing	ISAE	International Standard on Assurance Engagements
CCO	Chief Compliance Officer	KFS	Key Fact Statements
CDS	Credit Default Swaps	KIID	Key Investor Information Document
CFTC	Commodity Futures Trading Commission	KYC	Know Your Customer
CORE	Committee on Review of Eligibility Norms	MPF	Mandatory Provident Fund
CPF	Central Provident Fund	MiFID	Markets in Financial Instruments Directive
CRD3	Capital Requirements Directive 3	NEST	National Employment Savings Trust
DC	Defined Contribution	OTC	Over-the-counter
DCP	Defined Contribution Pension Act	PRIPs	Packaged Retail Investment Products
DoL	Department of Labor	SEBI	Securities and Exchange Board of India
EC	European Commission	SEC	Securities and Exchange Commission
EFAMA	European Fund and Asset Management Association	UCITS	Undertakings for Collective Investments in Transferable Securities
EIOPA	European Insurance and Occupational Pensions Authority	VAT	Value Added Tax
EMIR	European Market Infrastructure Regulation		
ERISA	Employee Retirement Income Security Act		
ESMA	European Securities and Markets Authority		
EU	European Union		
FATCA	Foreign Account Tax Compliance Act		
FFI	Foreign Financial Institution		
FIEL	Financial Instruments and Exchange Act		
FOFA	Future of Financial Advice		

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