

CA | ComplianceAsia

Presentation on Global Regulatory Changes

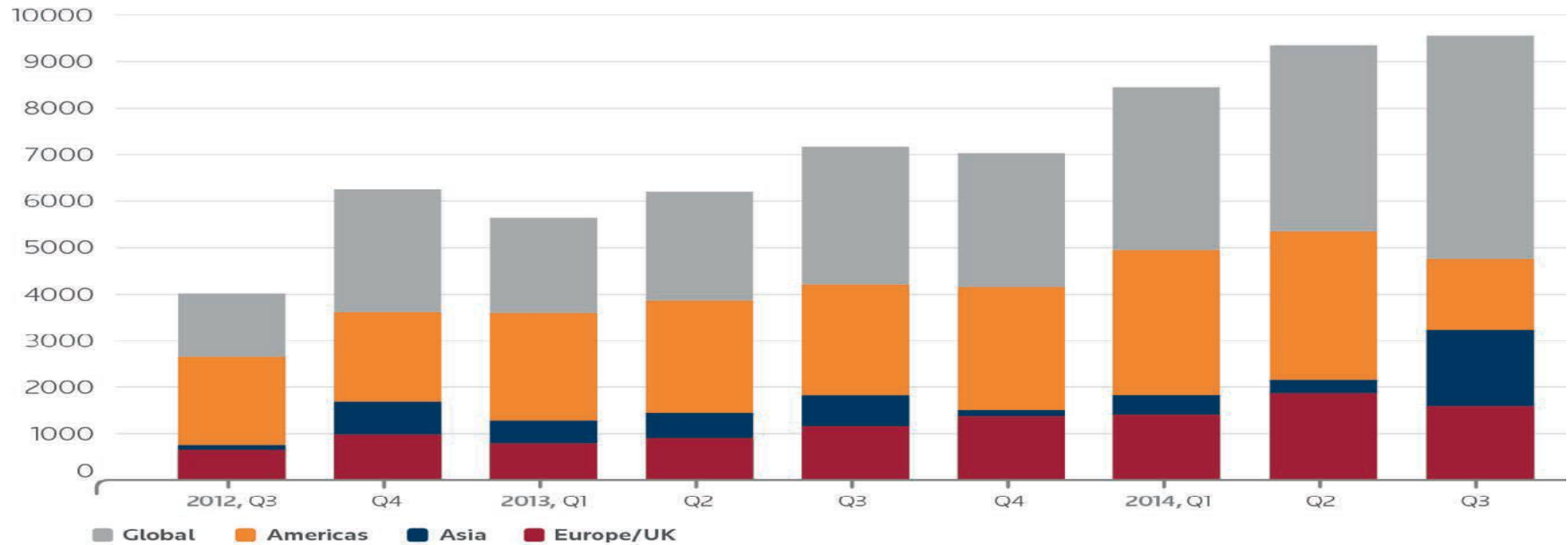
IMAS

January 2015

- EU Regulatory Changes
 - UCITS V
 - PRIIPS
 - MiFID II
 - ELTIFs
- MMFs
- Regulation of Benchmarks
- OTC Reporting – practical issues
- US Updates
 - Sanctions
 - Volcker Rule

Total Regulatory Changes 2014

Total Regulatory Alerts Year-On-Year



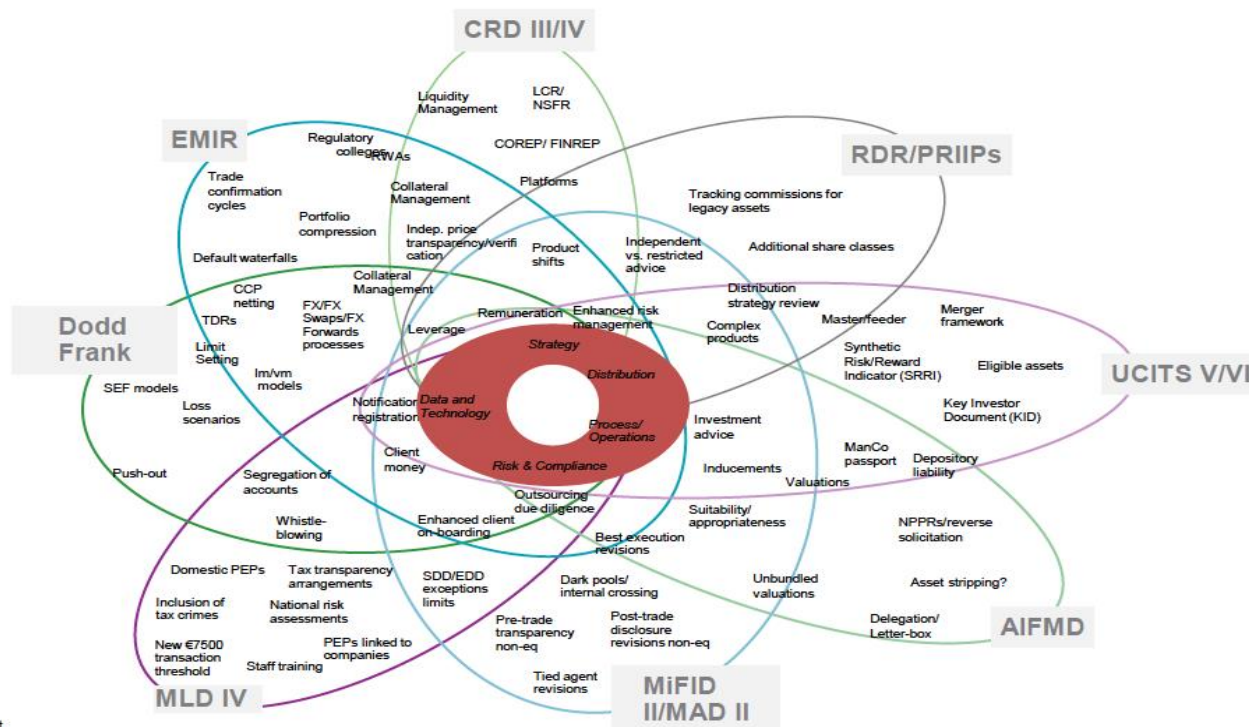
2013	26,898
2012	18,761

140

*NOTE: Tracked activity includes document changes, announcements and enforcements by regulators. Q3 Average Daily Alerts = Total alerts to September 30, 2014 / 261 working days

Example: Regulatory challenges in overlap

Key new regulations impacting asset managers will present a significant burden on asset managers



Note: The image on this page is not meant to be exhaustive, but seeks to highlight major impacts by regulation.

Many 'regulations' are still only at proposal, draft or consultation stage. Nevertheless, despite uncertainty and lack of finalisation in a number of areas, there is enough clarity that firms can begin to prepare for and respond to various regulatory challenges.

The landscape of the proposed regulatory reform is demanding and even a single subset is complex and overlapping

EU View of Asset Management Industry

- Perception of investment management industry among many policymakers is unhelpful: no difference made to investment banking, seen as short-termist speculators etc.
- Industry needs to change this perception by explaining how it connects to real economy
- EU has negative perception in member states but single European Market is key to industry success
- European economy is in deep trouble with resulting social problems and is main issue for policymakers. Investment management industry has to prove it is part of solution for financing gap left by banks, and not an additional problem.
- Industry must have increased focus on governance

Unprecedented wave of regulatory initiatives affecting the asset management industry

Regulatory initiatives at European level

Initiatives targeting specifically the European AM industry	Initiatives targeting financial institutions, comprising the European AM industry	Initiatives not targeting the AM industry but having spill-over effects
<ul style="list-style-type: none"> ▪ UCITS IV ▪ UCITS V ▪ UCITS VI ▪ ETFs ▪ Money Market Funds <ul style="list-style-type: none"> ▪ AIFMD ▪ Venture Capital Funds ▪ Social Entrepreneurship Funds ▪ Long-term investment funds 	<ul style="list-style-type: none"> ▪ PRIPs ▪ MiFID review ▪ ICSD ▪ Shadow banking <ul style="list-style-type: none"> ▪ EMIR ▪ EU Supervisory structure <ul style="list-style-type: none"> ▪ Short selling ▪ Financial Transaction Tax ▪ Corporate Governance 	<ul style="list-style-type: none"> ▪ Banking Union ▪ Recovery and resolution <ul style="list-style-type: none"> ▪ Liikanen report ▪ Basel III ▪ Solvency II ▪ IMD review ▪ Revision of IORP ▪ White Paper on pensions ▪ Credit rating agencies <ul style="list-style-type: none"> ▪ SLD ▪ Audit review
<div style="border: 1px solid black; padding: 10px;"> <ul style="list-style-type: none"> ▪ FATCA (US) ▪ Dodd Frank (US) ▪ Volcker Rule (US) ▪ European national initiatives to <ul style="list-style-type: none"> – Ban inducements (e.g. UK, NL) – Ban complex products (e.g. Belgium) </div>		



European Fund Distribution

Dimensions to Regulation

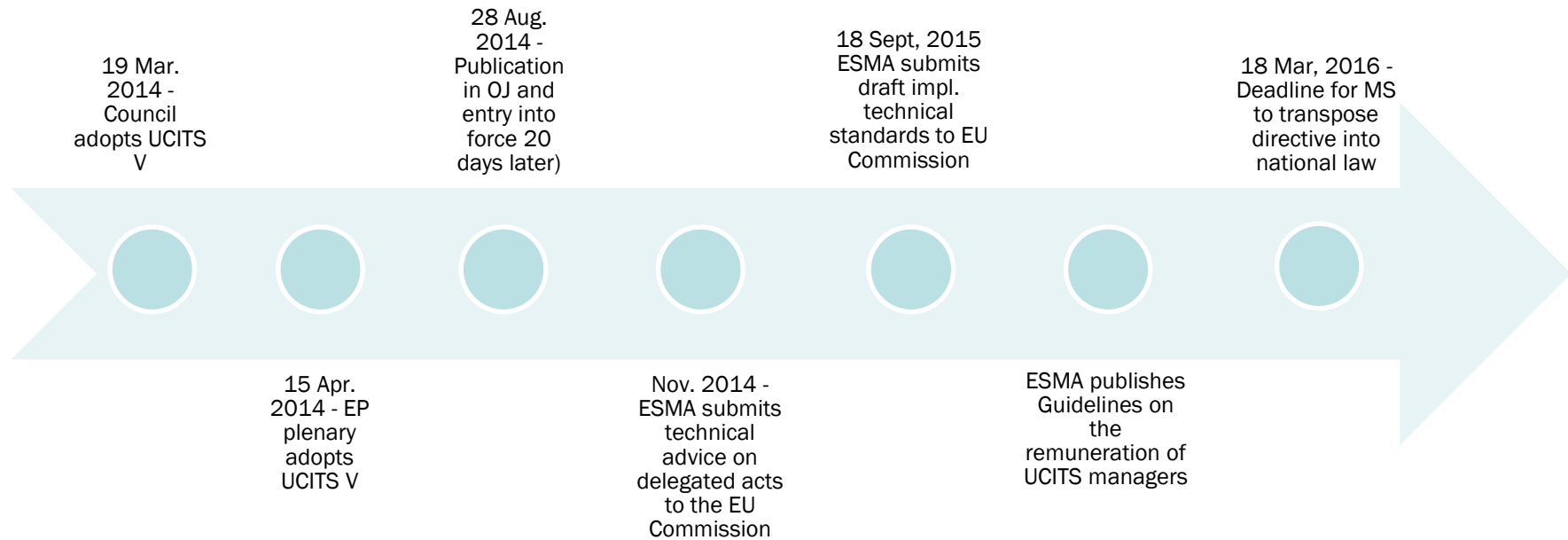
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UCITS V Review

- Alignment of UCITS framework AIFMD which has more investor protection
- Centered around 3 key aspects
 - **Remuneration rules** to discourage excessive risk-taking and align managers' incentives with long-term interests of retail investors
 - **Specification of depository functions** to include asset safe-keeping, cash flow monitoring and oversight of management company with strict liability regime for depository
 - **Sanctioning regime** to harmonise types of breaches and applicable administrative sanctions across EU jurisdictions and whistle-blower regime

UCITS V Timeline



Remuneration

- Categories of staff same as AIFMD and delegated managers
- At least 50% of variable remuneration to be paid in units of UCITS or equivalent non-cash instruments
- Percentage of variable remuneration to be deferred: at least 40% (or 60% in case of particularly high amount)
- Deferral period: to be aligned on holding period recommended to investors (at least 3 years)
- Disclosures on remuneration policies: KIID will have to include statement with cross-references to website where details of the remuneration policy are available

Depositories

- Eligible depositories: central banks, EU banks or entities subject to CAR & prudential supervision
- Clear definition of depositary functions: between safe-keeping, cash monitoring and oversighting management company
- Re-use of assets by depositary: only on account of UCITS and backed by high-quality, liquid collateral subject to title transfer.
- Strict liability regime for “loss”: depositary responsibility unless able to prove loss occurred due to external event, beyond reasonable control. Investors have direct rights
- Sub-custodian insolvency: depositories must ensure assets of UCITS unavailable for distribution to third parties

- Packaged Retail and Insurance-based Investment Products
 - EU has legislation for each type of financial products
 - Different disclosure requirements and no comparable key information for retail investors
 - Will apply to bank, asset managers and insurance companies
 - Establish uniform rules for all types of investment products for retail investors with common standardised document for key information limited to three A4-pages
- UCITS Funds
 - Given 5 year exemption on KIID and then under PRIIPs rules
 - Likely date of Autumn 2016

MiFID II - Background

- Markets in Financial Instruments Directive
 - Original MiFID implemented 2007 and still applicable
 - Governs provision of investment services in financial instruments by banks and investment firms and operation of traditional stock exchanges and alternative trading venues
 - Various investor protection measures
- MiFID II
 - Applicable from 3 January 2017
 - Greater regulatory requirements to take account of developments in technology and market infrastructure
 - Enhance investor protection
 - Maximise transparency and reduce data fragmentation

MiFID II Changes

■ Investor Protection

- Advisers have to state if advice is independent or not
- Ban on independent advisers receiving/giving third party fees, commissions or other monetary benefits
- Ban on portfolio managers receiving/giving third party fees, commissions or other monetary benefits
- Meaning of ‘complex’ products redefined to include all products with embedded derivatives, and some structured UCITS
- Definition of a consumer’s “target market” for a financial instrument at the level of the product manufacturer

MiFID II Concerns

- Roles and responsibilities of product manufacturer and distributor
 - Roles and responsibilities of product manufacturer and distributor are becoming more and more blurred leading to unclear separation of responsibilities and roles
 - Identified target market seems to supersede suitability & appropriateness test in various instances
- Disclosure of costs and charges of financial instruments and services
 - Already existing cost disclosure information, in particular the on-going charges figure (OCF)
 - Some ex-ante cost disclosures are impossible to predict and can be misleading – transactions costs

MiFID II and Research

- ESMA proposals
- Effectively banning investors paying for research
- Major disruption
 - Larger players can source in-house research favoured
 - Reduction of research for less liquid instruments and SMEs
 - Unlevel playing field between EU and non-EU investment firms
- De-facto ban inducements for non-independent advisers
 - Threaten open-architecture model

MiFID II – Investment Advice

- Shares in AIFs automatically excluded from execution-only regime
 - AIFs are complex and require advice prior to purchase
- Independent products
 - Products not having “close links” with manager - i.e. part of same group
 - Generally better meet client’s profile or needs
- Adviser must always provide cheaper and less complex alternatives
 - Better suited for client

MiFID II – Trading Transparency

- Same pre and post-trade transparency requirements for all venues
- Requirements calibrated for different types of instruments
 - Take into account interests of investors and issuers and government bond issuers
 - Market liquidity
- Requirements calibrated for different types of trading
 - Order-book and quote-driven systems such as request for quote
 - Hybrid and voice broking systems
 - Take account of transaction size / turnover / other relevant criteria

MiFID II – Trading

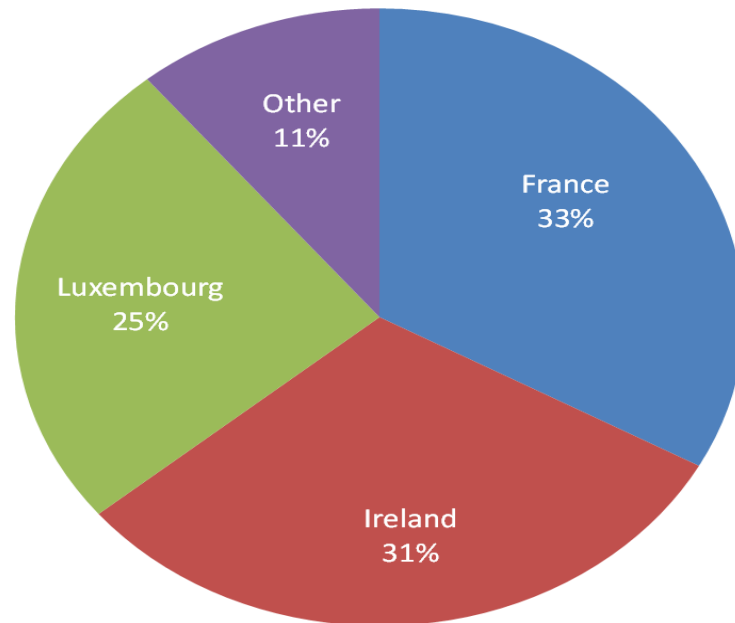
- Negotiated transactions
 - Volume caps and strict price improvement requirements
 - Limits on negotiated large equities transactions
- Liquidity
 - Disappearance of broker crossing networks for equities
 - Most trades are forced to be executed on trading venues,
 - Prop trading allowed only for bonds on OTF only and restricted to illiquid sovereign debt
 - Restrictive matched principal trading for all bonds & derivatives not subject to the clearing obligation
 - Reduced use of waivers apart from illiquid assets and non equities

MiFID II - Reporting

- Trading Venues
 - Obligation to maintain records of all orders and all transactions without exemption
- Reporting
 - Obligation to make pre- and post-trade data available separately and in reasonable commercial manner
 - Post trade transparency request reporting as close to real time as possible
 - Daily commodities reporting at national level and weekly to ESMA
- Similar rules apply to Consolidated Tape Providers
 - Must report that computer algorithm by investment firm responsible for the investment decision
 - Must report execution of the transaction or a free information must be made available free of charge max. 15 minutes after publication

Money Market Funds in Europe

MMFs are significant part of EU asset management industry, with almost E1 trillion AUM



Domicile of European Money Market Funds
(Percentage of total AuM)

Regulation of MMFs

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- G20 Summit asks FSB to provide recommendations on shadow banking
 - In 2012, IOSCO publishes policy recommendations on MMFs
 - In 2013, EU publishes a proposal for regulation on MMFs in Europe
- Aim to ensure MMFs more resilient to redemption pressure in stressed market conditions by enhancing their liquidity profile and stability
- MMF regulation **difficult** for industry and regulators
 - No consensus about nature of problems or solutions

Industry and MMFs

- Eligibility of assets: MMFs should be allowed to invest in units of other MMFs
- Securitisation: MMFs should be allowed to invest in wider range of securitisations
- Diversification: rules should be closer to UCITS rules
- Ban on use of external credit ratings: MMF managers should have choice of deciding whether to follow CRAs' reviews
- Liquidity ratios: scope of eligible assets should be broadened
- 3% capital buffer for CNAV MMFs: this would render CNAV MMFs commercially unviable and lead to withdrawal of up to EUR500 billion of financing to companies, banks and governments

Impact of US MMF Reform

- US Institutional Investors may not be able to
 - May not be permitted to invest in a Floating NAV MMF under applicable corporate charters
 - May not be willing to invest in a MMF that can impose a liquidity fee and/or redemption gate
 - May lead to increased investments in Government MMFs or other alternatives (bank deposits, private funds, etc.)
 - May lead to reduced demand for prime MMFs, which could result in reduced demand for commercial paper
 - May lead to higher short-term borrowing costs

- Regulation in 2013 on European Long Term Investment Funds
 - Financing constraints due to enhanced capital requirements for banks (Basel II / CRD IV)
 - Need alternative sources of financing for long term projects
 - ELTIF is funding vehicle especially designed to meet that need
 - Will be entitled to EU passport
 - No redemption rights until end of life time of ELTIF which is set
- Investments
 - Invest in equities or debt instruments of non-listed entities, loans granted by ELTIF to those entities, units or shares of other ELTIFs or VC funds, direct holdings of real assets and UCITS eligible assets
 - No securities lending, short-selling, derivatives instruments allowed (except for hedging)
 - Maximum 30% on liquid assets and minimum of 70% on illiquid assets
 - Diversification rules provisions similar to the ones of UCITS apply
 - Strict rules on borrowing of cash

Regulation of Benchmarks

- **July 2013 - IOSCO's report on Principles for Financial Benchmarks**
 - Scope of benchmarks covered very broad
 - Create overarching framework of principles for benchmarks
 - Recommend application of principles proportional to size and risks of each benchmark
 - Detailed principles to address benchmarks having specific risks arising from their reliance on submission and/or ownership structures.
- **Main areas covered**
 - Governance - responsibility of administrator, responsibility of third parties involved in setting process, conflicts of interest
 - Quality of Benchmark – transparency, data sufficiency and hierarchy of data inputs
 - Accountability - complaints process, documentation standards and audit reviews
- **No recommendations addressing users of benchmarks**

Regulation of Benchmarks

- **EU status**
 - EURIBOR, LIBOR but also a wide range of other financial benchmarks
 - Equivalency decision for third party countries
- **Japan**
 - Scope of the legislation broad but only TIBOR so far
- **USA**
 - Current scope cover benchmarks for derivatives traded on regulated exchange
 - Precede IOSCO principles and no plan to adopt complying legislation
- **Singapore**
 - Recent consultation and still considering FX benchmarks
 - Key financial benchmark, based on systemic importance and susceptibility to manipulation- SIBOR and SOR

Regulation of Benchmarks

- **India**

- RBI implementing framework for financial benchmarks,
- Mumbai Interbank Bid Rate (MIBID) and Mumbai Interbank Offered Rate (MIBOR)

- **Hong Kong**

- Supervisory measures in relation to HIBOR fixing mechanism.
- Code of Conduct for Benchmark Submitters

- **Canada**

- OSFI responsible for supervising effectiveness of governance and risk controls associated with banks' CDOR (Canadian Dealer Offered Rate) submission processes
- Guidelines have been issued in respect of submissions process

- IOSCO consultation paper
 - Develop methodology enabling regulators to identify financial institutions, other than banks or insurance companies that are of global systemic relevance (G-SIFIs)
 - 5 main impact factors
 - Size, interconnectedness, substitutability, complexity and global activities
 - Assess systemic importance of asset managers/investment funds
 - Examine securities lending, risk management, etc. of asset managers
 - Consider if investment funds more meaningful unit of analysis rather than asset managers

- Financial Stability Oversight Council
 - Established by Dodd-Frank Act
 - 10 voting members
 - Authority to designate systemically important financial institutions
AIG, GE Capital, Prudential
 - SIFs subject to enhanced prudential standards – not yet determined
 - Monitor for financial stability risk
 - Authority to recommend enhanced standards
 - Suggested that asset management could pose threat to financial stability – potential for rapid redemptions, potential for destabilizing asset sales
 - Conclusions widely criticized

G-SIFIs – Industry Response

- Agency business model
 - Asset managers not source of systemic risk
- Regulated investment funds
 - UCITS or AIFs should not be considered systemically important
- Size alone not appropriate criterion to assess systemic relevance of investment funds
 - Better indicator is scale of activities of fund and level of leverage
- Level playing field
 - Materiality thresholds for size should be applied in same manner across all jurisdictions

Central OTC Clearing Risks for Managers

- **Legal risks**
 - CCPs and CMs are protected by recovery and resolution measures
 - Fund and asset managers are not protected as they are third-parties to clearing models and have no protection other than negotiated contracts
 - Contract negotiation may result in lower protection for end clients during reviews of existing contracts.
- **Concentration risks**
 - Limited number of clearing members
 - IT costs are too high to allow diversification

Increased Costs of OTC Clearing

- Legal Costs
 - New sets of contract to change execute client clearing agreement / master agreement / collateral management agreement
- Operational Costs
 - Need to adapt or duplicate reporting
 - Upgrades to operations team
- Opportunity Loss
 - Assets blocked in clearing structures
 - Disappearance of remuneration for asset deposited as collateral with clearing members
 - Initial margining reducing investment capabilities

CCP asset segregation: Omnibus

Pros

- At CCP level
 - Easier access to asset to ensure resolution and lower prices
 - Reduces costs
- At CM level
 - Easier to ensure collateral provision and reporting
 - Reduces costs

Cons

- At CCP Level
 - Delays to recall assets
 - No legal certainty for market participants due to lack of identification of the owner
 - Wider risk spreading without controlled damage certainty
 - Country treatment of cash collateral not aligned
 - No remuneration of collateral posted
- At CM Level
 - No legal certainty for clients due to wider risk spreading than on own accounts
 - Cost increases rely on contractual bargaining
 - Delays to recall asset
 - No remuneration of collateral posted

CCP asset segregation: Segregation

Pros

- Legal separated operationally commingled
 - Reduces costs and easier to ensure recall
 - Ensures differentiated treatment of assets
- Asset segregation
 - Most secure way to safekeep assets for asset managers
 - Avoids any risk of co-mingling between funds
 - Co-mingling between sub-fund is illegal for most EU funds structures

Cons

- Legal separated / operationally commingled
 - Cost increase left at contractual bargaining discretion
 - National legal treatment of cash collateral is not aligned
- Asset segregation
 - Increases costs through CM servicing fees
 - Increased IT cost and operational risk due to duplication of operational flows

Future of OTC Derivatives

- Increased pressure on OTC derivatives
 - Increasing capital requirement on sell-side when entering in OTC derivatives transaction
- Alternatives
 - Increasing interest on use of swap forwards
 - Avoiding CCPs
 - Structuring transactions differently
- Actions to take
 - Check and challenge legal conditions in new documentation
 - Challenge costs and fees
 - Cost and Benefits analysis to assess benefits of using OTC derivatives before entering in new model

Legal Entity Identifiers

- Origins
 - G20 requirements to identify each and every counterparty to each financial transactions, needing standardised
 - Different initiatives launched (CICI, LEI) at different national levels to ensure this effectiveness of numbering exercise and the numbering agencies
- Asset managers constraints
 - Mandates
 - Pools
- Urgent need to ensure no duplicate reporting

US Sanctions

- Rapid developments in US sanctions, esp Russia and Iran
 - For **Iran**, recent developments positive but delays
 - For **Russia** outlook is more negative with potential for additional US measures against entire sectors
- Asian-based asset managers may be subject to US sanctions laws
 - Branch of US company
 - Subsidiary of US company (for certain sanctions programs)
 - Involvement of US nationals, subsidiaries, affiliates or partners
 - Use of US dollar denominated transactions
 - Engaging in certain activities involving Iran

Extension of US Sanctions

- If you are not subject to US sanctions, your business partners and other third parties may be
 - May require you to certify that your activities in compliance with US sanctions before agreeing to partner with you or provide services to you
 - Fund administrators, custodians and other related parties have become more aggressive in investigating and reporting potential sanctions issues
- Additional measures
 - Provide specific advice to US person employees and personnel involved in cross-border activities
 - Screen third parties against sanctions lists
 - Consider sanctions compliance representations in agreements

Volcker Rule

- Final rules approved in December 2013 but compliance period extended until July 21, 2015
 - Exclusion provided by final rules for UCITS and similar foreign public funds from covered fund status creates possibility that such funds could be treated as banking entities
 - Banking entities are generally prohibited from engaging in prop trading, and business of investment funds involves prop trading, designation as banking entity would effectively prohibit fund from engaging in business
 - Exemption for trading “solely outside the United States”, but exemption not permit purchases or sales to be conducted with or through any U.S. entity, except under certain conditions with foreign operations of a U.S. entity or with U.S. entity acting as intermediary

UCITS = Banking Entity

- Banking entity is broadly defined
 - Non-U.S. banks with U.S. banking operations and “affiliate” of banking entity
 - Affiliate means any company that *controls*, is *controlled by* or *under common control with* a banking entity
- Control is defined broadly to include
 - ownership of 25% or more of a fund’s voting securities
 - control over the election of a majority of the fund’s directors
 - ability to exercise controlling influence over management or policies of fund
- Governance structures of UCITS and non-U.S. funds differ from U.S. registered funds, so more likely be deemed banking entities
 - Need relief from Volcker rule

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