Winning the global regulation game
Implementing the right strategy could save cost, capital and time
Executive summary

The number of new legislative initiatives implemented following the global financial crisis (GFC) of 2007-08 brought the asset management sector into the glaring headlights of politicians and regulators, with regulation becoming vastly more intrusive across the globe.
• Asset managers with marketing exposure or clients in the US find themselves subject to the enhanced jurisdiction of the U.S. Federal Reserve, the U.S. Securities and Exchange Commission (SEC) and the U.S. Commodity Futures Trading Commission. And for the first time, those same firms also may fall under the jurisdiction of regulators based in the European Union (EU) and European Economic Area (EEA) because of the extraterritorial or anti-avoidance principles of some of the measures. The ongoing globalization of financial regulatory policy – as well as continued fragmentation – creates significant challenges for the industry as it seeks to develop seamless, firm-wide, global compliance systems rather than managing compliance on a purely jurisdiction-by-jurisdiction, regulation-by-regulation basis.

• For many asset management firms, legacy data management and reporting systems in place prior to the GFC are unlikely to be sufficient to effectively meet the new upcoming complex global compliance challenges in a cost-effective and timely manner.

• In addition, partly due to the priorities from politicians and partly due to the complexity of implementing current regulations themselves, new measures continue to be proposed, and others are taking longer for regulators to agree upon than originally expected. The restructuring of the entire compliance environment and the continued globalization of regulatory policy will continue for the foreseeable future. The only certainty in planning for future compliance is that uncertainty will continue.

• The costs of compliance can prove excessive. This is especially the case in the EU, where most firms are still spending heavily on improvements to the financial market infrastructure in the securities, derivatives and payments markets as well as focusing on navigating the onslaught of regulatory reform. In the U.S., by contrast, most firms are now in a post-GFC cycle of focusing on growth. However, if the right firm-wide strategy is implemented, waste is eliminated and cross-functional synergies are created, and firms should be able to defray anything up to an estimated 30% of future implementation costs compared with the highly inefficient process of dealing with each regulation on an isolated, form-by-form basis.

• Institutions of all sizes can benefit from outsourcing functions in their back, middle and front offices to convert fixed costs into variable costs, manage market and reference data challenges, and, thus, cost-effectively build economies of scale and expertise. However, any outsourcing program must be managed diligently, given that regulators are highly concerned about the creation of “letter-box entities” and potentially hidden systemic risks. Competent authorities in EU jurisdictions, such as the UK and Germany, are meanwhile conducting thematic reviews and enhanced audits to further develop their understanding of the risks involved in this area.
Winning the global regulation game

Complex chaos
Since the GFC, regulators in the U.S., Europe and Asia, often inspired by the Group of Twenty (G-20) and the Financial Stability Board, have been racing against each other to implement many new regulations targeted at managing systemic risk, improving public revenue collection, and enhancing transparency and investor protection. Heavily motivated by politics and fueled by an electoral sentiment strongly in favor of greater transparency and accountability, many measures are underpinned by more stringent regulations, coupled with tighter controls on excessive risk. In the current climate of widespread public scrutiny, few politicians are willing to stand up and argue for fewer regulations, less monitoring of systemic financial risk and less investor protection. As a result, the free-for-all by policymakers to implement more regulations and broaden the jurisdictions and enforcement power of regulators, sometimes conflicting across different jurisdictions, has reshaped the global compliance landscape into what can seem like a state of complex chaos.

Summary of some major new regulatory initiatives with cross-border implications

Universe of regulatory challenges
Key new regulations impacting asset managers will present a significant burden

- Total cost to the industry of implementing all measures highlighted could represent an increased cost and income ratio (CIR) of some two to three basis points over the next three to five years.
- Digging up the road over and over again to comply with every regulatory measure is not an effective option, particularly as an estimated 20% to 40% of this future cost will arise from duplications involving client onboarding, booking models, transaction reporting and record retention.

Many regulations are still only at the proposal or consultation stage. Nevertheless, despite uncertainty and lack of finalization, there is enough clarity that firms can still begin to prepare for various regulatory challenges.

The landscape of the proposed regulatory reform is demanding, and even a single subset is complex, overlapping and likely duplicates other regulatory data requirements.
Winning the global regulation game

Traditional approaches of assessing the impact of individual regulations had been focused on dealing with each regulation in isolation on a piecemeal basis. Compliance, regulatory reporting and establishment of required procedures could be treated as narrowly defined functions, often carried out on a jurisdiction-by-jurisdiction, report-by-report or form-by-form basis. This approach may have worked in the past, but it is now suboptimal, costly and unsustainable in the new environment. Given the scale and magnitude of regulatory change now under way, the CIRs of many asset managers could increase two to three percentage points or even more during the next three to five years. To aggressively protect margins, asset managers urgently need to adopt a new enterprise-wide, holistic business operating model that should minimize costs, eliminate duplicative and wasted efforts, and ensure future flexibility, while meeting all regulatory obligations.

In light of these challenges, asset managers across the globe have been forced to look at restructuring their reporting frameworks, data architectures and internal processes in order to address global regulatory requirements by implementing a more cost-effective, scalable, firm-wide strategy. As part of developing a new industry strategy, we have reviewed key new asset management regulations collectively across multiple jurisdictions – as opposed to an insular, regulation-by-regulation approach.

In carefully analyzing some of the most prominent regulatory measures, Ernst & Young LLP (EY) has extracted common themes across various operational dimensions to provide a more consolidated view of the many firm-wide data management and operational changes required. Our approach is highly scalable and flexible and accommodates in-flight regulatory projects at global, regional and local levels.

Importantly, as part and parcel of implementing a new global compliance strategy, a clearly thought out plan of attack must be put in place and effectively communicated throughout the entire organization. A typical compliance strategy for a firm to restructure in order to adapt and win in the new environment might include the following:

- Analyzing global regulations that have a single legal effect and directives that must be transposed into national laws that are deemed relevant from across jurisdictions
- Identifying documentation filing requirements and their respective timelines per the effective dates for compliance
- Reviewing identified regulatory requirements and comparing them with existing capabilities and performing a gap analysis for each regulation
- Designing and implementing systems to address gaps identified, as well as transition strategies to help firms maintain profitability
- Ascertaining market trends and responses from peer group firms, outsourcers, vendors and market infrastructure providers in order to establish standards and determine the most commonly applied leading practices in the industry
- Analyzing the commercial impacts of the new regulations and exploring potential synergies, as well as business development opportunities

Winning in the new regulatory environment of complex chaos is largely a matter of controlling costs as well as optimizing capital provision and innovation. The clients of asset management services have become increasingly sophisticated and price sensitive. Implementing a new regulatory framework comes at a cost – and the markets are now in a period when investors are seeking to cut overall costs wherever possible. As a result, profit margins are squeezed, thus making aggressive cost management paramount for a firm to achieve and maintain a competitive advantage. Essentially, managing the wave of new global regulations while controlling costs is a formidable challenge in both data management as well as process automation.
Data, data, data: the era of “big data”

A smart strategy put in place to survive and win in the new regulatory environment is effectively all about data: sourcing data, managing data and processing data. On top of the sheer quantity of data reporting now required, the amount of data communicated to regulators and the frequency of communication have spiked. Regulators are demanding entirely new types of data – such as risk- and remuneration-related reporting required by Form PF and the Alternative Investment Fund Managers Directive (AIFMD) – as well as data that firms must retain in order to show evidence of compliance. This is not surprising. Over the last two decades, with the increasing globalization of capital markets, investors and regulators have steadily become far more demanding in terms of the information needed from both managers of publicly listed corporations as well as managers of investment funds. On the positive side, the data requests required by each new regulation from different regulators in different jurisdictions are not entirely unique. Diverse filing requirements involve significant areas of overlap but also many differences, making managing reporting to separate jurisdictions a complex job. Effectively, little is brand new about data requests from regulators – there are now simply a lot more requests about a lot more data.

Again, in meeting regulatory requirements, the focus for asset managers should be primarily on data, data, data. Financial data is created, controlled and extracted from a variety of sources within the firm and across several functionalities, as well as geographies. Whether that source is front office, middle office, back office, fund administrator, prime broker or custodian, or whether the data is domiciled in New York, London or Mumbai, the right compliance strategy must integrate and meticulously coordinate all data sources across the entire firm. On top of continuing to demonstrate compliance with global regulations, the right data management strategy can also be readily leveraged to manage risks and win the business development game as well. As regulators require more and more reporting that demands more interactive data management systems, firms can opportunistically take advantage of using their new data systems to most effectively support their sales, marketing and client communications efforts.

Above and beyond simply meeting filing deadlines, there exists a compelling business case why firms should look at redesigning their entire enterprise-wide data architecture and enthusiastically take on the challenge of big data. Amid plummeting marginal costs for vastly more robust and powerful data processing speed and storage capabilities, it is both practical and highly cost effective for companies to analyze entire data sets instead of just subsets – such as examining client transaction histories across the firm as opposed to simply focusing on trading activity in just one particular asset class.

Analysis of multi-structured data involving a series of different data sets may produce additional insight that can be used to enrich what a company already knows and possibly reveal previously unknown opportunities. This means much more accurate business insights can potentially be produced to help improve business performance. For many asset managers, analyzing more data more thoroughly to get small improvements of even 50 basis points in many key performance indicators (KPIs) can deliver tangible and valuable results in terms of profitability and growth.
Commercial advantages that big data can deliver: it’s not just about form filing

- Enhancing risk management across client segments and the entire enterprise
- Deepening “know your client” (KYC) insight
- Implementing aggressive fraud detection and shoring up cybersecurity defense
- Identifying clients presenting the most revenue potential or value in terms of actual revenues
- Monitoring product-specific metrics (sales, profitability) regressed against market environment
- Identifying potential client and market demand for new products
- Identifying clients at risk of defecting to competitor firms
- Determining the effectiveness and return on investment (ROI) of costly marketing campaigns
The greatest challenge: small to midsize firms

At a recent US asset management industry conference, one chief executive officer indicated that the new regulatory environment has solidified the dominance and cost competitiveness of a handful of giant asset management firms. The largest firms command the scale, head count and budgets to implement new internal procedures and information systems at far lower marginal costs than smaller ones. Effectively, small to medium-sized firms with limited budgets for enhanced compliance staff and new information systems are now presented with an enormous challenge to compete with larger firms.

Some smaller asset managers, lacking the deep pockets and huge head count that large, bulge-bracket firms command, may find the rocky road ahead and the complex chaos of the new regulatory environment nothing short of a threat to their survival. Nonetheless, small and medium-sized firms can “buy in” expertise and scale through smart outsourcing. Asset management firms of all sizes can benefit from a highly developed and competitive market for asset servicing – particularly in the US and Europe. The core functionality of almost all asset servicing firms is to deliver leading-class expertise, economies of scale and a high degree of adaptability – both on the upside and downside – on highly cost-effective terms.

By comparison, following the 2001 recession and the downturn in trading volumes from traditional asset managers, prime brokers rapidly adjusted their business model to meet the demands of the wave of new start-up boutiques by establishing hedge fund hotels. This initiative on the part of brokers entailed providing new firms with a variety of incubator services – such as capital introduction, risk management systems and office space. Likewise, today the outsourced asset servicing industry is expanding product offerings to win business from even the smallest firms and start-ups by providing comprehensive regulatory services that cover many of the more than 40 regulatory filing requirements applicable in the US market alone.

As a case in point, more than a dozen major outsourced fund administrators are now actively marketing their services for filing the highly onerous Form PF required by the SEC. In the EU, countless law firms and consultants have aggressively courted new business to manage the entire process of Undertakings for Collective Investment in Transferable Securities (UCITS) and AIFMD registration.

An understanding of the landscape of service providers and pricing plans, as well as how to successfully implement a strategic outsourcing program, should ease an enormous amount of the compliance regulatory burden on senior management, many of whom typically prefer to focus on business development and portfolio management. Through implementing a program of outsourcing key compliance-related functionalities, small and medium-sized firms can retain a competitive edge in the industry, regardless of the complex chaos of the regulatory landscape. The classic business model of a small fund starting with little more than an office, a telephone, a prime brokerage account and a Bloomberg terminal is by no means dead and buried. But this needs to be done with care; regulators across the globe are vigilant in ensuring that firms have the capacity and competency to oversee outsourcing arrangements – and mere letter-box investment entities are a subject of specific concern. However, smart outsourcing can serve as a cost-effective means to bring in leading-class expertise and scalability to even the smallest start-up entrepreneurial firm.
Winning the global regulation game
Implementing the right strategy to adapt to the complex new global regulatory environment in the most efficient manner is by no means an overnight process. Apart from rebuilding an efficient, firm-wide data infrastructure that identifies, extracts and aggregates financial data across multiple global sources, a firm should also establish a precise timeline and road map that encompass each and every regulatory requirement. From domestic regulatory measures such as the Foreign Account Tax Compliance Act (FATCA) and the Dodd-Frank Act in the U.S. and Retail Distribution Review (RDR) in the UK, to regional measures such as AIFMD and the European Market Infrastructure Regulation (EMIR) – as well as UCITS V/VI, the Markets in Financial Instruments Directive (MiFID) II, Market Abuse Directive (MAD) II, Solvency II and Packaged Retail Investment Products (PRIPs) proposal to come – each new regulation will carry with it a unique set of data requirements, reporting deadlines and compliance challenges. Each regulation will require an impact assessment to determine which, if any, firm products are exposed to the new regulation, especially when regional and national approaches are compared.

Broadly speaking, a firm can very broadly categorize all new regulations into either bucket one or bucket two with a smart data infrastructure in place. This step-by-step bucket approach allows each firm the flexibility to prioritize implementation of what management sees as the most essential near-term requirements and also helps customize a firm-wide compliance strategy to take into account in-flight regulatory projects.

Bucket one: immediate or near-immediate, need-to-file regulations. These likely will be the national “must do” measures that are presented as a thematic priority in each country (e.g., client asset protection in the UK and Luxembourg; inducements for Switzerland, France and the Netherlands; managing conduct in the Netherlands or the UK; or front-office controls in France, Germany, Italy and the UK), plus the more developed regulations by way of technical standards such as FATCA and the Dodd-Frank Title IV, VI and VII measures, as well as measures such as EMIR, AIFMD and UCITS V in Europe. Firms most likely have already reviewed their product line in relation to these types of regulations and concluded that implementation is, in fact, required and a hard filing deadline is on the horizon. In particular, EY has assisted asset managers to help design and implement a reporting framework for regulations that not only have a widespread impact for the industry, such as AIFMD, but also require data that substantially overlaps and may even conflict with other requirements.

Bucket two: while it is tempting to define this bucket as “everything else,” this category more specifically encompasses regulations that are on the horizon, such as MiFID II, MAD II, PRIPs, Insurance Mediation Directive (IMD) II and the Central Securities Depositories (CSD) Regulation. Because regulators have not finalized them, many have not yet initiated impact assessments at the time of this writing to uncover the devil in the details. Examples for asset managers in the EU, for example, might include the Shadow Banking Regulations or data privacy measures. Planning to comply with future unwritten regulations is no doubt highly challenging. No firm wants to spend time and energy preparing for draft regulations still in development that may never be actually implemented or that may change during the rule-making process. It is useful to put in place cross-functional teams dedicated to each individual key regulation with subject matter specialists who can best understand the impact of regulations, both individually and collectively.
Not just the regulators: investors have become more demanding as well

Rebuilding the compliance infrastructure across a firm should not be treated merely as a means of keeping many regulators across many jurisdictions happy. Instead, given that the due diligence process conducted by institutional investors across the global markets has rapidly intensified over the last few years, potential investors will likely focus on the same pointed questions as regulators – particularly for issues related to risk management, operations, performance reporting and valuation. Post-GFC, there have been market scandals involving benchmarks or foreign exchange (FX) manipulations as well as a smaller number of investment management scandals that were more limited in scope but nonetheless were widely reported in the media. Many institutions now take the “trust but verify” approach to due diligence and selection of asset management firms. Essentially, the type of data that regulators may ask firms to collect and report for analysis is also highly similar to the type of data institutional investors will seek to collect and analyze as well.

Managing reputational consequences or poor risk controls is becoming a critical focus in 2014. In the EY 2012 Global Hedge Fund and Investor Survey, 56% of institutional investors questioned indicated that operational risk concerns – above and beyond investment performance – would cause them to redeem assets from a manager. Further, when asked where specifically they want their allocated fund managers to direct further capital investments in technology, 68% of investors surveyed indicated risk management and 51% indicated compliance as key areas to target future information technology (IT) spending. Essentially, rebuilding infrastructure and implementing a more robust reporting system for a variety of new global regulatory requirements can be viewed as meeting customer concerns and being part of front-office business development. As the financial bubble and the era of double-digit returns appear to be behind us, investors have substantially raised the standards they demand from their asset management firms in terms of disclosure, operational risk, data infrastructure and transparency.

In short, implementing a smart strategy for firm-wide, cost-efficient global compliance is not just about saving money and avoiding enforcement actions and bad publicity – it is also all about helping grow the topline in a very tough market environment among increasingly skeptical investors.
**Examples of top regulatory priorities**

- Remuneration (CRD IV, AIFMD, UCITS V, MiFID II, Dodd-Frank)
- Thematic (client money) – FCA, CSSF
- Thematic (CSAs, company visits, wall-crossing, research) – FCA
- Thematic (front-office controls) – FCA, AMF, BaFIN, CONSOB
- Thematic (advised sales) – AMF, CNMV, CONSOB
- Thematic (fund changes) – FCA, AMF, BaFIN, FI
- Thematic (outsourcing) – FCA, BaFIN
- Thematic (conduct, conflicts) – FCA, AMF, AFM
- Thematic (platforms, JVs) – FCA, AFM, CONSOB
- Thematic (inducements) – FCA, AMF, AFM, FINMA
- AIFMD (NURS, SPVs, partnerships)
- UCITS V into VI
- EMIR
- MiFID II and MAD II
- MMF Regulations
- ETF Regulations
- Shadow banking regulations
Organization changes

Prior to the GFC, compliance and regulatory risk management typically sat in the compliance department of wealth and asset management firms. The compliance department structured its reporting and processes to make life as easy as possible for the business ownership, or “front office,” without interfering with day-to-day operations. For its part, the business focused on the core competencies of the firm – namely portfolio management and top-line growth of both AUM and revenues.

Today, the compliance environment has expanded and demands enterprise-wide structural change. For one, EU regulators have stressed the importance of three separate lines of defense:

• The business: Serves as the ultimate owners of the compliance and enterprise regulatory risk management to the extent that it becomes a priority at the C-suite level. The business takes responsibility for the management of regulatory and enterprise wide risks and puts in place the processes necessary to manage the risks. It operates within a clearly defined framework and risk appetite.

• Compliance and risk departments: Provide ongoing reporting and monitoring of all enterprise operations, including sales, marketing and trading, as well as traditional risk management focusing on market, credit, liquidity, operational and conduct risk. However, the compliance department alone can in no way ensure effective risk management 100% of the time. The chief risk officer (CRO) must serve as an equal partner with – and not merely a supportive advisor to – the CFO and CEO. The boundaries of acceptable risk must be clearly established and communicated.

• Internal audit: Ensures that data capture by compliance is timely, accurate, sufficiently granular and efficiently reported to the business.

Key functions of C-suite to confront continually changing risk and regulation:

• Embed prudent regulatory risk management into the firm’s corporate culture

• Establish and maintain independent duties of the risk function, providing value far beyond merely “filling out paperwork” for senior management

• Ensure that proactive and prudent compliance monitoring is in place, with any breaches quickly identified and immediately escalated to the CRO and senior management

• Consider the full range of compliance risks across all relevant jurisdictions, markets and products – present and future

• Establish and monitor quantifiable metrics, not merely board qualitative ideas

• Ensure defining risk appetite is distinct from development of group strategy

Building the new target operating model: key factors

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Winning the global regulation game
Conclusion

A number of legislative provisions are coming out of both the US and EU that will likely have a global impact on the industry. While they cover similar overlapping functionalities and have similar reporting requirements, the new regulations may be inconsistent in some cases. Even the most sophisticated legal experts specializing in financial compliance firms can find it challenging to interpret and fully understand the many complex inconsistencies of the new regulatory environment, particularly given that many of the rules are in various stages of drafting and implementation.

To effectively comply with the entire range of new regulatory initiatives, most firms are looking to design and implement a new business operating model that will restructure enterprise-wide data architecture and systems. Some of the key demands for a new operating model include the following:

- Mitigating increases in costs through automation and elimination of duplicative processes, wherever possible
- Increasing data, reporting and record-keeping capabilities, including near-real-time reporting
- Restructuring over-the-counter (OTC) derivative and repo operations, including clearing, settlement, reporting and collateral management
- Restructuring risk management systems, including policy review, new tiers and categories of risk, and operational risk control enhancement
- Implementing new business processes
- Reviewing commercial relationships: custodians, prime brokers, administrators and commercial banks
- Reviewing middleware providers
- Investing in infrastructure
- Enhancing trade reporting and electronic connectivity
- Reviewing the legal framework and documentation, such as International Swaps and Derivatives Association (ISDA) master agreements
- Reviewing product suites and marketing materials

Managing the ever increasing complexity of the regulatory environment through investment in technology and talent – while also aggressively controlling costs – is a top challenge for most EU firms

### Managing the ever increasing complexity of the regulatory environment through investment in technology and talent

- **Compliance with regulatory requirements**
  - Total (40) - 82%
  - Americas (21) - 81%
  - Europe (19) - 84%
- **Cost pressure**
  - Total (40) - 30%
  - Americas (21) - 47%
- **Investment product innovations**
  - Total (40) - 19%
  - Americas (21) - 26%
- **Technology innovations**
  - Total (40) - 18%
  - Americas (21) - 21%
- **Resource skills/talent management**
  - Total (40) - 18%
  - Americas (21) - 26%
- **Data management and reporting**
  - Total (40) - 18%
  - Americas (21) - 29%

Appendix

Tax

FATCA

The FATCA was enacted into US law as a provision of the Hiring Incentives to Restore Employment Act (U.S. HIRE) in 2010. FATCA is intended to counter offshore tax avoidance by U.S. persons by strengthening the information reporting by third-party payers, typically financial institutions.

Within the US, US investment funds are classified as withholding agents. Outside the US, FATCA affects all foreign financial institutions (FFIs), US withholding agents and their customers worldwide. The definition of FFI is extremely broad and would likely include all managed funds. Any non-US entity that would be called an “investment fund,” “hedge fund” or any similar classification would most likely be categorized as an FFI. All of an FFI’s global-affiliated financial institutions will therefore fall within the category of either an FFI or a US withholding agent. For non-US entities, FATCA is an extraordinarily far-reaching piece of national legislation, yet another that will affect firms far beyond their home jurisdiction.

Most major firms categorized as FFIs likely will enter into an agreement with the Internal Revenue Service (IRS). If not, they are classified as “nonparticipating FFIs.” Such nonparticipating FFIs, as well as US persons who do not permit their FFI to disclose account details to the IRS, will face 30% withholding on certain US-source payments.

Financial Transactions Tax (FTT) Directive

The concept of an FTT was initially supported by 11 EU participating Member States (PMS) and was approved in the European Parliament in December 2012 and then by the Council of the European Union in January 2013. A lengthy drafting process coordinated across the EU was designed, in theory at least, to avoid fragmentation of the single financial services market in Europe to ensure that the financial sector makes a contribution to public finances, and to discourage transactions that do not contribute to the efficiency of the financial markets. Under the current draft directive, not only would the asset management industry (including collective investment schemes) operating within the PMS be exposed to FTT on its financial transactions, but non-PMS counterparties conducting transactions with PMS-based entities potentially would be as well. So far, the proposed minimum charges are 1% of the total underlying principal of derivative transactions and 10 basis points on secondary market transactions of financial securities. For electronic transactions, FTT would be payable when the tax becomes chargeable. Exemptions permitted in the current draft of the directive are much narrower in scope than other pre-existing corresponding transaction taxes, such as the UK stamp duty regime. Except in limited circumstances, FTT would likely apply to every financial institution that is party to an in-scope financial transaction, with no provisions for netting permitted.

Continued uncertainty around the exact final shape of the proposed FTT Directive makes planning for changes in operational infrastructure difficult. Already, the initial January 2014 proposed deadline has passed, and internal debate within the EU continues.

Nonetheless, in one form or another, the PMS authorities most likely will implement an FTT. The major remaining questions are related to the timeline for implementation and the exact shape of the final regulation. One important outstanding question, particularly for the asset management industry, is whether transactions in the units or shares of collective investment schemes could be within the scope of any final FTT Directive. With a final directive, however watered down it may be from the initial draft directive issued in February 2013, asset managers will be required to review and adapt their business model to ensure that they have an FTT-efficient structure and the necessary systems to capture and record the FTT that is due. Key questions also remain as to which collection and reporting systems will be needed in the asset management value chain.

FTT has already been introduced under national regimes in France and Italy and has been discussed for introduction in other countries, such as Portugal and Spain. The FTT is a classic example of an ostensibly local regulation having an extraterritorial global effect far beyond the jurisdictions in which it has been enacted.

To say the least, there has been considerable debate and pockets of opposition throughout the PMS. For example, the UK has led a number of other countries staunchly opposed to the FTT. In April 2013, the UK’s Chancellor of the Exchequer filed a challenge to the implementation of the FTT with the Luxembourg-based European Court of Justice. Further, perhaps as an indication of deep-seated, underlying ideological differences, serious discussion about such a transaction tax has not occurred in the US.
Market infrastructure

The Dodd-Frank Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act, also known as the Dodd-Frank Act, seeks to promote financial stability by reducing systemic risk in the economy and enhancing investor protections. For the US financial services industry, the 2,100-page piece of legislation is arguably the most complex law affecting the financial services industry. The act restructured the US financial regulatory regime by requiring enhanced reporting to regulators and increased transparency to investors, fundamentally changing the permitted investment activities of banks, and demanding additional market infrastructure and consumer protections. We anticipate rule-making and implementation to be at the forefront of the regulators’ agenda for the next several years, and such legislation likely will be subject to intense political lobbying and debate. The Dodd-Frank Act and the surrounding debate over the complex rule-making process will continue to drive change across the industry, including how firms structure and operate themselves and their investments, how they interact with counterparties, their ability to take risk and how they interact with customers.

Key regulatory changes and impacts include the following:

- **Title I** covers the promotion of financial stability through the creation of the Financial Stability Oversight Council (FSOC), composed of senior members of US regulatory agencies. FSOC has broad powers to address systemic risk to the economy, including the ability to enhance the monitoring and governance of certain institutions by designating them as systemically important financial institutions (SIFIs).

- **Title IV** requires the registration of advisers to private investment vehicles. In addition, these types of advisers are now subject to specific reporting requirements related to the private funds being managed (Form PF).

- **Title V** institutes the monitoring of the insurance industry by the Federal Insurance Office in the US Treasury.

- **Title VI** (the Volcker Rule) attempts to allay systemic risk by limiting banks and their affiliates’ risk-taking capabilities through several steps: a prohibition on proprietary trading, limitations on a bank’s ability to invest in funds, an expanded application of “Super 23A” prohibitions and the implementation of a Volcker Rule compliance program.

- **Title VII** drives for transparency and accountability on Wall Street through regulation in OTC derivatives markets, including centralized clearing and settlement.

Capital Requirements Directive: CRD IV

CRD IV is a package of prudential requirements that apply to many asset management firms with effect from 1 January 2014, subject to some transitional provisions. Based on Basel III, CRD IV applies to banks and a broad range of other financial institutions across all of the EEA. Most asset management firms likely fall within the scope of CRD IV. Where there is a group of companies, the existence of a CRD IV-covered firm within the group can bring the group within the jurisdiction on a consolidated basis.

Some key areas of impact:

- Calculation of regulatory capital resources is potentially tougher with the new requirement to deduct deferred tax assets and effectively account for pension fund deficits.

- Increased quality of capital is required. Upper Tier 2 and Tier 3 capital categories are removed. The ratio of common equity Tier 1 and Tier 1 capital is now significantly higher.

- In calculating regulatory capital resources, one favorable change for asset managers is that their own holdings in open-ended funds are no longer subject to deduction. This is particularly helpful for asset management firms that hold seed capital.

- Credit risk calculation is administratively more burdensome because the standardized approach must be followed since the previously available simplified approach is no longer available.

- Increased common reporting Integrated Common Reporting (COREP) requirements now include capital adequacy reporting for all firms and increased financial reporting (FINREP) requirements for some groups. Both of these require reporting through eXtensible Business Reporting Language (XBRL). There is also increased tax reporting with a potential impact on firms operating in different countries.

The European Commission has committed to review the prudential regime for investment firms in 2015 as an acknowledgment that these banking-based CRD IV requirements may not be the most appropriate for investment firms. Thus, there may be a new prudential regime for asset managers beginning around 2018.
EMIR

The EMIR, like the Dodd-Frank Act, will mandate central clearing for standardized contracts and impose risk mitigation standards for non-centrally cleared contracts. There will also be wide reporting requirements. The clearing obligation will apply to both financial counterparties and nonfinancial counterparties that exceed certain thresholds, and it will apply broadly to most OTC derivatives.

EMIR’s key regulatory changes:

- There are increased reporting, process and people requirements – transaction reporting by February 2014 and exposure and collateral reporting by August 2014.
- All standardized OTC and exchange-traded derivatives will be required to be cleared through a central clearing party (CCP); initial and variation margin treatments will be finalized for an effective date of December 2015.
- There are increased trade confirmation, portfolio compression and reconciliation arrangements effective September 2013. Risk weights for non-centrally cleared instruments will be announced.
- The current six announced trade data repositories will be administered by the new European Securities and Markets Authority (ESMA).

MiFID II

The MiFID has been the cornerstone of capital markets regulation in Europe since its first implementation in 2007. With new amendments, MiFID II, the second version of the highly encompassing directive, was published by the European Commission in 2011 and has been progressing through the EU negotiation and decision-making processes since then. MiFID II likely will be finalized in the form of a single legal effect regulation (called MiFIR) and a directive form (MiFID II) to take effect by the end of 2016 at the earliest, and it will be introduced to coincide with other overlapping regulations likely to impact asset manager firms, such as MAD II, PRIIPs and IMD II. Some of the many areas that are addressed include the following:

- Trading operations: order routing and client-order handling will need to be reconfigured, as will quote-driven markets such as fixed income and OTC-traded instruments, including interest rate, credit default and FX swaps.
- Widely encompassing product coverage: the pre- and post-trade transparency regime under MiFID I will be extended to a very wide range of products, such as exchange-traded funds (ETFs), Global Depository Receipts (GDRs) and most OTC derivative and commodity instruments, including emissions trading.
- Market structure: a new category of venue called the Organized Trading Facility (OTF) will be introduced for non-equity trading and may cover single- and perhaps inter-dealer platforms. The OTF category will be in addition to the extant regulated market, multilateral trading facilities (MTFs) and systematic internalizer (SI) categories of venue.
- Position limits and trading restrictions: MiFID II implements trade restrictions and position limits set by the ESMA, with the potential for deferral for certain economically structural commodities, such as oil and coal.
- Algorithmic trading: although still permitted, a more restrictive regime covering high-frequency and algorithmic trading will be introduced with greater focus on disclosure and on risk management considerations (such as margin requirements and leverage).

Investor protection: rules are expanded, new asset classes are included and investor categories are modified; there are also likely to be rules and limitations on “inducements” paid between product providers and distributors.
Asset management-focused provisions:

**AIFMD**

The AIFMD is one major element of the EU’s response to the GFC. It covers management, administration and marketing of alternative investment funds (AIFs) and focuses on regulating the Alternative Investment Fund Manager (AIFM) rather than the alternative fund itself.

AIFMD establishes an EU-wide, harmonized framework for monitoring and supervising risks posed by AIFMs and the AIFs they manage, as well as for strengthening the European market in alternative funds. Driving factors for AIFMD include more transparency; more disclosure; more filing requirements; and, in theory at least, more investor protection.

EU-based managers can apply for an AIFMD passport for operations and marketing activities that fall within AIFMD’s jurisdiction. The UCITS passport will allow them to operate across borders around the EU. In the long run, AIFMD – along with the UCITS regime – is part of the effort to strengthen the market for EU asset management firms to compete both within the EU as well as globally.

**Form PF**

While the EU was negotiating and implementing AIFMD, in the US, the Dodd-Frank Act introduced the new Form PF reporting requirement under its Title IV. This provision applies to managers of alternative funds. The coverage of Form PF and risk-related reporting requirements are somewhat similar to the broad jurisdiction and reporting requirements of AIFMD. Form PF reports received by the SEC and AIFMD reports received by EU regulators will be scrutinized both at national and global levels. In particular, among G-20 regulators, the Financial Stability Board and the International Organization of Securities Commissions (IOSCO) will use reported data to determine whether asset management activities can present systemic risk, as well as how to measure the risk created and which measures should be taken to mitigate that risk. While the regulatory debate on asset managers impacting systemic risk is ongoing, new regulatory initiatives targeted at fund managers with the intention to control risk could be significant, particularly for larger managers.
Distribution: RDR

A domestic UK regulatory initiative, the wide-ranging RDR was first developed by the Financial Services Authority (FSA) and is now being implemented by the FSA’s successor regulatory body, the Financial Conduct Authority (FCA). The new law came into effect in January 2013. The RDR seeks to improve the quality of investment advice available to UK investors by improving the clarity with which firms giving investment advice describe their services, restructuring remuneration practices to eliminate conflicts of interest and raising professional standards. In addition to banning commission payments from asset management firms to client investment advisors, the RDR also covers the remuneration of investment platforms, banning payments by product providers to such platforms.

Key provisions:

- Retail client advisors banned from receiving payments from product providers: the cost of advice must be fully disclosed and agreed upon in advance with the client.
- Description of services: advice is to be classified as either “independent,” in which case it must cover the whole of the market for investment products, or “restricted.”
- Professional standards: advisors must be more highly qualified than previously and undertake continuing professional development.

Impact on asset managers

UK distributors must restructure their business models and remuneration policies. The FCA has clamped down on attempts to “get round” RDR, insisting on the spirit that no payments in any form should be permitted between product providers and distributors. There is considerable interest in other parts of the globe in developments in the UK’s RDR. RDR-like provisions may be incorporated into MiFID as part of an EU inducement ban on payments to advisors – as a ban has already been implemented in the Netherlands. Australia is implementing a similar initiative, and a number of other national regulators, such as South Korea, have also announced an intention to ban commissions paid to distributors.
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