

# GLOBAL REGULATORY OUTLOOK

2016

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## VIEWPOINT 2016

Opinions on global financial services regulation and industry developments for the year ahead

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### About the Global Regulatory Outlook

Our fourth annual Global Regulatory Outlook reports aim to assist the global financial services industry with navigating the key regulatory and financial services developments in 2016 and beyond.

This report, Viewpoint, explores findings from our survey with 193 financial services professionals (including 98 senior executives) from across the world, which was conducted from September to December 2015. The research aimed to gauge the industry's perceptions on regulatory developments and issues impacting businesses. Perspectives and practical guidance on regulatory themes for 2016 are also provided in this report from industry and Duff & Phelps experts.

Insight, a supplement publication to Viewpoint, is a technical document which outlines key regulations, requirements and deadlines by jurisdiction applicable to the asset management, brokerage and fiduciary industries.

We would like to sincerely thank all of the professionals who took part in the survey and contributed perspectives to this year's Global Regulatory Outlook reports.

If you have any questions or comments, we would be pleased to hear from you. You can also sign-up for our regulatory alerts and other communications at [www.duffandphelps.com/subscribe](http://www.duffandphelps.com/subscribe).

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## Executive Summary

Regulation is a barrier to growth and competitiveness. The cost of compliance is rising. Global coordination is not happening fast enough. These are just some of the sentiments from the financial services industry about regulation identified in our fourth annual Global Regulatory Outlook (GRO) 2016 survey with 193 professionals from around the world. Is regulation deserving of such a negative view? The industry can't ignore the need to adapt as the enforcement agencies are circling.

Without question, the financial services industry is vital to the success of the global economy. In the US, the industry contributed \$1.26 trillion to GDP in the same year – 7.2% of GDP.<sup>1</sup> Financial services and insurance contributed £126.9bn to the UK economy in 2014 – 8% of the UK's total Gross Value Added. London – voted second only to New York as the leading financial center, according to our survey – was responsible for half of this amount.<sup>2</sup>

Other financial centers provide a similar story. For Hong Kong and Singapore for example – smaller hubs in international terms, but even more reliant

on financial services – the figures are 16.5%<sup>3</sup> and 12.2%<sup>4</sup> respectively. Moreover, the financial services industry in all these countries underpins the rest of their economic activity – both commercial and personal.

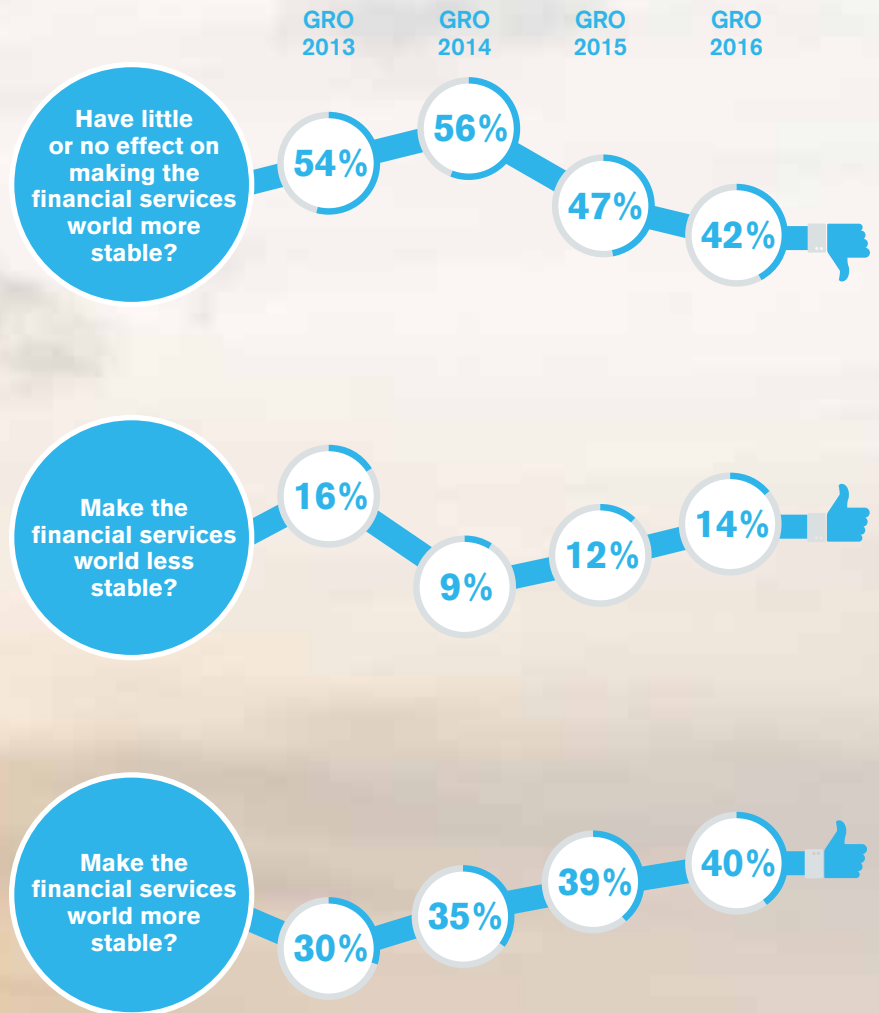
Whether the regulatory environment reflects the importance of the industry remains open to debate, however.

On the one hand, as economic confidence in some markets circles grow, seven years on from the onset of the financial crisis, there are finally calls from those in power for “banker bashing” to



Figure 1 - DO YOU BELIEVE THAT FINANCIAL SERVICES REGULATION WILL:\*

\* Note: the figures do not include respondents who selected "Don't know"



end. As UK Chancellor George Osborne said in a speech last year: "Our financial services industry in Britain has, in recent years, been seen as part of the problem – now it must become part of the solution."<sup>5</sup> Government sources in the UK talk of reaching a "settlement" and of achieving stability with a new regulatory regime.<sup>6</sup>

On the other hand, many in the industry question just how successful this settlement has been – and how stable it is.

**Cui bono?**

While the industry's opinion on the impact of regulation continues to soften year on year, the GRO 2016 survey shows significant ambivalence remains. More still think recent financial services regulation has little impact (42%) or makes the financial services world less stable (14%) than think it will make it more stable (40%). Those leading organizations are particularly doubtful about its benefits: half of C-Suite respondents say recent regulation will do little or nothing to promote stability, while 18% say it will make it less stable – more than two-thirds in total.

<sup>1</sup> <http://selectusa.commerce.gov/industry-snapshots/financial-services-industry-united-states>  
<sup>2</sup> [www.parliament.uk/briefing-papers/sn06193.pdf](http://www.parliament.uk/briefing-papers/sn06193.pdf)  
<sup>3</sup> 2013 figures <http://www.censtatd.gov.hk/hkstat/sub/sp80.jsp?tableID=189&ID=0&productType=8>  
<sup>4</sup> In 2013 <https://www.mti.gov.sg/MTIInsights/Pages/Financial-Services-Sector.aspx>  
<sup>5</sup> <https://www.gov.uk/government/speeches/mansion-house-2015-speech-by-the-chancellor-of-the-exchequer>  
<sup>6</sup> <http://www.ft.com/cms/s/0/eb8b6b1a-0b84-11e5-994d-00144feabdc0.html#axzz3rwpLgGg>

The proportion saying regulation will help rebuild consumer confidence, meanwhile, has declined since last year, from 43% of all respondents to 31% this year. It's also lower than average in some leading financial centers: 29% in the US, 27% in the UK and just 20% in Hong Kong, compared to 37% elsewhere.

Despite the flood of regulation, and most worrying of all perhaps for regulators, is the proportion that think regulatory changes have done enough to prevent a future crash is still negligible: just 6%, the same figure as it was in 2015.

### Top of mind on the regulatory agenda

The above findings may simply reflect the limitations of what regulation can achieve. There are, after all, few guarantees with financial markets. However, the depth and breadth of regulation continues to expand, with new requirements on firms and new areas brought within regulators' remits.

Of the latter, cyber risks are an increasing focus for both firms and regulators. Increasing attacks on financial services firms and other industries have prompted cybersecurity regulations and guidelines from the US SEC and the Hong Kong SFC, among others.<sup>7</sup>

It is not surprising then that respondents expect cybersecurity to take its place as a top priority for regulators. In total, 19% expect it to be the number one priority for regulators in 2016, against 18% for AML and KYC requirements, and 15% for efforts to ensure a firm-wide culture of compliance.

These results for cybersecurity were largely driven by US respondents, where 35% expect regulators to prioritize their focus on this area. In the UK, it was lower, at 12%, with compliance culture (22%) expected to be the focus for regulators – a

reflection, perhaps, of the Senior Managers and Certification Regimes being introduced for banks and likely the wider industry.

Furthermore, in response to regulatory oversight, survey respondents expect to enhance their valuation processes through the use of independent external valuation advisors (16%). This is closely followed by increasing disclosures surrounding valuation estimates (15%).

### Global regulatory coordination

At the same time, firms must be mindful of not just their own regulators' requirements, but also those of foreign regulators assuming jurisdiction of activities overseas. The extra-territorialism pioneered by the US, for example, with its FATCA is now firmly established. In 2016-2017, firms across the global industry will also be making final preparations for two new regimes: Europe's MiFID II and the global Common Reporting Standard.

While more respondents agree (42%) than disagree (17%) that there have been improvements in cross-border coordination, only 17% (of which, just 12% of chief executives) think regulators have been effective in establishing consistency globally. Few also (16%) expect to see unified global regulatory standards in the next five years.

Clearly not having consistent requirements internationally presents a significant and complex compliance challenge for global firms. But there are opportunities for efficiencies in international firms' compliance from taking a holistic view of the global regulatory landscape. There is also a danger of understating the significant harmonization efforts and improvements in the industry's standards that have been achieved, particularly with differences in priorities, cultures, budgets and operational structures between regulators and governments.

<sup>7</sup> <http://www.financemagnates.com/fintech/bloggers/firms-cannot-afford-to-ignore-the-dangers-of-cyber-security-non-compliance/>

### Counting the cost

The effect of regulation inevitably leads to a rise in the cost of compliance. Our survey finds that 85% expect regulations to increase their costs this year. The remainder remained unsure; none however disagreed. With a complex regulatory environment and further game changing developments in the pipeline (MiFID II for example), it's hard to disagree with the industry on this burden.

As it is, the overall cost of compliance is already substantial: 34% estimate their firms spent 1-4% of annual revenue on compliance in the last year, and more than a quarter said they spent even more – roughly one in five split evenly between spending 4-7% and spending 7-10%, and one in fourteen saying they spent more than a tenth of their revenues on compliance.

That's expected to increase substantially in five years' time. By then, 28% expect to spend 4-10% annually (although most of those below 8%) and one in five expect to spend more than 10% of annual revenues on compliance. These findings are consistent across geographies.

Most of this increase is likely to be driven by investments in technology and, particularly, people – with both staff numbers across compliance roles and salaries increasing, as well as the use of external advisors. Recruitment drives in compliance from big banks over recent years have been matched by salary increases reflecting both the competition for talent and increasing responsibilities.

Costs are likely to be impacted, too, by increasing pressure for personal and senior management accountability. Respondents to the survey are divided – 34% think increased accountability will deter prospective talent, 28% disagree. Specifically in the UK, which has gone further than elsewhere in defining how regulation may

Figure 2 - IN WHICH AREA DO YOU EXPECT REGULATIONS TO FOCUS ON MOST IN 2016?\*

\* Note: the figures do not include respondents who selected "Don't know"

#### Cybersecurity



#### Anti-money laundering and KYC issues



#### Firm-wide culture of compliance



#### Liquidity management



#### Client suitability/mis-selling



#### Marketing practices to investors/customers



#### Proper disclosure for investors



#### Fee and expense allocation



#### High-frequency and electronic trading



#### Manipulative trading strategies





enforce such accountability, 44% agree that it will deter prospective talent (against 33% in the US and 20% in Hong Kong).

The same uncertainty exists when considering the impact on people already in the industry. 25% agree and 26% disagree that it will discourage existing talent. Furthermore, 32% felt making executives personally criminally responsible for the actions of employees within their firms will have a positive impact on the industry, as opposed to 35% who believed it will negatively impact the industry.

Part of the industry's view on the rising cost of compliance is also likely down to the increase in enforcement action and financial penalties over the past few years.<sup>8</sup> Three quarters of respondents expect enforcement actions by regulators to increase either moderately (60%) or significantly (13%) in 2016.

New enforcement actions – against both firms and individuals - will undoubtedly continue to be felt in coming years. The industry and regulators

must be wary, however, of the danger of firms 'budgeting' for such fines and ultimately passing the costs onto shareholders and consumers. If this happens, the entire point of delivering penalties will be lost.

### **An unsustainable future?**

It has to be asked whether this cost on firms can last. It is not simply a question of whether such costs are justified given the limited effectiveness the majority of respondents give the regulations credit for, although this is certainly something worth examining. It is also the extent to which regulations actually support both the industry's competitiveness and governments' goals for and requirements from the sector.

Fewer than one in five (18%) of those in our survey expect regulations to strengthen customer access, against 40% who disagree; likewise, only 18% think regulation will boost product and service offerings, while 46% disagree. Despite the small improvements in global coordination, meanwhile, firms are similarly doubtful regulations will help expand their geographic market reach (19%).

<sup>8</sup> <http://www.duffandphelps.com/expertise/publications/Pages/GER2015.aspx>.





Overall, there seems little confidence by the industry that regulations necessarily make for a better experience for customers or ensures financial services firms are able to stay competitive.

There is, however, further action firms themselves can take. The lack of global coordination in regulations does not preclude efficiencies that can be achieved through coordinated compliance efforts internally, for example. Likewise, despite recognizing the importance of cultural change, firms' approach to compliance in some respects still fails to reflect this. 58% in the C-Suite and 49% overall said the firm's culture was the single most important factor in a governance function for avoiding regulatory problems, well ahead of the next highest answer of ensuring governance has a place in the boardroom (26%).

Yet when respondents were asked the skill sets firms look for when hiring compliance teams, they continue to focus on technical knowledge of the regulations (38%). Practical experience in trading or operations (15%) and leadership or team management skills (15%) lag well behind. If firms are to truly achieve a cultural change, it is hard to see how this can

be achieved without such skills, particularly on the leadership front to drive change efforts. Nevertheless, Duff & Phelps' work with the industry has shown an increasing number of firms do recognize this.

More broadly, at least some (24%) see scope for regulation to enhance their competitive advantage. To ensure the continued contribution of the financial services sector to their economies and constituents, regulators and governments must also look to themselves. In particular, as new innovations come to light such as those we are seeing in the FinTech and cryptocurrency worlds, regulators must collaborate with the industry to develop rules that are effective, proportionate and do not impede industry growth.

To borrow a phrase from the UK Chancellor, they need to ensure that regulation continues to be part of the solution, not part of the problem.

# INDUSTRY DISRUPTION AND CHANGE

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## Blockchain Will Help Regulators Help Themselves

Since the financial crisis, increased inquiries from federal agencies have imposed a serious regulatory burden on financial services companies. Often, the state of current technology places financial services and government regulators at odds.

Compliance has become a costly obligation because there is no uniform standard for maintaining data, and many institutions keep multiple layers of legacy databases they have acquired through mergers. Reconciling accounts across multiple, separately maintained ledgers is arduous.

When I previously served at the New York Department of Financial Services, it would take scores of people, months if not years, and millions of dollars to complete transactional “look backs” on financial institutions. Seven years later, the complex transactions of Lehmann Brothers are still getting sorted out. In 2016, if a free Google search can gather information in an instant, why should financial reviews take infinitely longer? Of course, regulators can't use a Google search to do their work. But here's where blockchain

technology can lift the burden. A blockchain is a decentralized consensus ledger that produces an automatically verified account of possession and exchange. When a trade is confirmed, it is cryptographically entered onto a “block,” then added to the “chain,” which carries the full transactional history of the asset.

By implementing a shared ledger, all players in the transaction have a consistent body of data that is accounted for by all market participants and can never be changed. The data is maintained in a format that creates a level of transparency that is extremely helpful to regulatory bodies. The practice of mobilizing massive resources and labor to collect information will, in time, become extinct because blockchain technology will make the data available instantly.

But regulators must also seize this opportunity to modernize. The present supervisory structure - much like the Tower of Babel - challenges both sides of the industry, and solving that problem will prove mutually beneficial. Regulators should update their own technology infrastructure, retool, and retrain their workers. If this can be done, then the agencies can help convince companies to make the blockchain transition, exerting huge influence on the marketplace.

Huge cost reductions are another benefit of streamlined, digital transactions. According to a report jointly authored by Santander InnoVentures, Oliver Wyman, and Anthemis Group, the blockchain is projected to “reduce banks’ infrastructure costs attributable to cross-border payments, securities trading and regulatory compliance by between \$15-20bn per annum by 2022.” Just imagine the financial benefits if other types of transactions were included.

Rather than disrupting an industry, the blockchain can enhance the financial services ecosystem with more efficient record keeping. The founders of itBit foresaw this remarkable development and became the only chartered trust company operating a clearing and settlement network using blockchain technology. Moving forward, itBit will continue to work with government agencies to build a more effective regulatory scheme.



## Regulatory Focus on Cultural Change



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In principle, the regulatory focus on bringing about cultural change in banks is sound. Ensuring those working in banks (as well as asset managers and elsewhere) instinctively behave with integrity and in the best interests of customers and markets relieves regulators of the impossible task of anticipating where the next case of abuse will occur.

In practice it is more complicated. For a start, organizational culture remains difficult to define and assess. For instance, the exact details of FCA's "conduct risk" initiative remain vague: deliberately so, perhaps, since the regulator is keen to be principles-based and avoid reducing the initiative to a list of rules.

Two definite regulatory strands can be discerned, though: one is the focus on remuneration and the EU rules we have already seen come into force; the other is the focus on personal liability, for which the international template may prove to be the UK's Senior Managers Regime. Greg Medcraft, chair of the International Organization Of Securities Commissions (IOSCO) has backed adoption of such a scheme in his home nation of Australia,<sup>9</sup> for example, while Mary Jo White, head of the US SEC has described the changes as "intriguing."<sup>10</sup>

The emphasis on personal liability makes sense in light of the potential for the cost of ever-escalating fines simply being passed on to customers. Any

reputational risks have long since been dampened by the fact that almost all banks have been penalized. And the focus on culture is being felt in firms; assessments of individuals' integrity when hiring are being given as much weight as their technical skills in some cases. Indeed, the Global Regulatory Outlook shows that the industry considers that firms consider the culture of the company the most important factor to get right to avoid regulatory issues.

Nevertheless, delivering cultural change will remain challenging for regulators. For a start, the difficulty with definitions represents a barrier to regulatory coordination. It is hard to apply standards internationally when they are not defined at home. There are also risks that the pursuit of accountability through personal liability will see some professionals choose to leave financial services or head for less regulated parts of the industry. Finally, despite public disapprobation, it is not clear how far abuses can be fully attributed to cultural flaws peculiar to the industry. If they can, how do we explain recent revelations of emissions rigging in the automobile industry?

In any case, if fundamental change is to be delivered, it is going to take time and effort by all of those in the industry. It may ultimately require generational change before the cultural change regulators want to see is truly achieved.

**William Mason**  
Director General  
Guernsey Financial  
Services Commission

## COMMENT

*"Cultural transformation within the financial services sector is a prerequisite for addressing what some have termed 'regulatory fatigue.' Some firms have always been good while others have made significant improvements. Regrettably, there remain firms who have failed to understand that the Social Darwinism enshrined in their cultures is abhorrent to their fellow citizens. Are there regulatory simplifications which should be made, has the pendulum swung too far in some areas – absolutely! That, however, does not excuse the moral voids at the heart of some financial services firms which must be filled."*

<sup>9</sup> <http://www.ft.com/cms/s/0/44b666a0-16a1-11e5-b07f-00144feabdc0.html>

<sup>10</sup> <http://www.ft.com/cms/s/153b9f28-15b9-11e5-be54-00144feabdc0.html>

## Challenges for Global Regulatory Coordination



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Financial service firms remain frustrated with the level of cross-border coordination between regulators. While the majority (42%) believe regulators are improving efforts towards global coordination, 52% of respondents believe efforts to date have not been effective. Furthermore, only 16% of respondents believe unified standards are imminent within the next five years.

This is not surprising, and it's difficult to argue with the industry's verdict that there's still a way to go to realize unified standards. However, this risks simultaneously understating what has been achieved and over-estimating what is possible.

On the one hand, it is difficult to compare today's regulatory landscape with that of even a decade ago and fail to see the distance travelled. It is not just the international regulation, but significant moves towards implementation, too. September, for example, saw final technical standards published by the European Securities and Markets Authority (ESMA) for the Markets in Financial Instruments Directive II (MiFID II), the Market Abuse Regulation (MAR) and Central Securities Depositories Regulation (CSDR). The standards set out how the legislation applies in practice to market participants, infrastructures and national supervisors.

On the other hand, there clearly remain significant compliance challenges for international firms, particularly when it comes to those operating on both sides of the Atlantic. These will persist in the foreseeable future. Even with transatlantic regulation outlining

identical requirements, cultural differences between regulators and their enforcement regimes on each side would undermine any globally standardized approach.

Overall, however, the harmonization that has been achieved should not be ignored for a number of reasons. First, despite differences, there are many opportunities for efficiencies in international firms' compliance and competitiveness from taking a holistic view of the global regulatory landscape.

Second, it is important to recognize the decreasing opportunities for regulatory arbitrage. Despite some threats (which should not be taken lightly by local regulators and governments), relocations prompted purely by a desire to escape regulatory requirements remain rare. You can run, but you can't hide, as the adage has it.

Finally, moves – both formal and informal – towards regulatory coordination in terms of both depth and scope continue. This means, for example, that the recent focus of the Commodity Futures Trading Commission on cybersecurity is likely to be picked up by other regulators. Ultimately, the pressure for greater harmonization remains as strong as ever. Firms would therefore do well to look to new priority areas focused on by regulators – wherever they are based – as an indication of what may be coming to their shores.



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# Regulatory Implications of Technology in Financial Services

The basic economic proposition of new technologies is speed, efficiency and convenience. Some of the most interesting areas to benefit from technological innovation relate to payments and settlement, information and distribution, securities registration, and identity verification.

However, new technologies also create risks in the delivery of financial services, as well as dependencies on technology operators. They change the way we identify ourselves to product providers. They also change the nature of disclosure, i.e. how we figure out whether a product is the right one for our needs. So safety, security and suitability are issues for both the providers and the users of financial services.

The task for financial authorities is to determine which risks could do the most damage to consumers, firms and the financial system in the event of the failure of these technologies. The starting point for such regulatory engagement is the monitoring of technological developments

through research, the gathering of market intelligence and the collection of data. This initial step in the spectrum of regulatory engagement supports analysis and policy assessments, and will inform debates on whether new technologies, new activities and new entities should be brought within the perimeter of regulation and supervision.

Clearly, new technologies present a wide range of regulatory challenges. For example:

- What activity should we measure and what new data will we require?
- Who should we collect this data from? Do we need to draw new types of firms or activities inside the regulatory perimeter?



- How do we assess which technologies are likely to have the greatest impact in the future (to avoid wasting resources considering every innovation)?
- Do we need new legal and regulatory definitions? E.g. what is a virtual currency?
- How do we adapt existing concepts? For example, marketing is a key concept in different parts of financial regulation. In what sense are YouTube videos marketing when search engines are optimized to find them?
- How should financial authorities, which are typically public bodies, compete with the private sector for expertise, which is in great demand?
- Do we need to develop new supervisory (as opposed to monitoring) tools and methodologies? For example, in securities markets supervision, we have been monitoring social media for the possibility of detecting insider trading for some time.
- As the spectre of a disruptive cyber-attack looms, how should firms and financial authorities be positioned strategically – should the balance of focus be on prevention or on the management of failure?

Often, disciplined regulatory engagement may be overtaken by events. There is an ever-present prospect that the waves of technological change will advance at such a pace so as to alter the financial services landscape before regulators have had a chance to gather data or assess the potential consequences and before industry has had a chance to invest in solutions to address these risks. In such circumstances, regulatory policy debates may be driven by political imperatives and the need to be seen to react.

Capability must be created to take timely and proportionate action. In a world where technology expertise is in great demand, financial authorities face similar challenges as industry in adapting to face the significant challenges of resourcing, coordination and organization.



## Assessing Cybersecurity Risks



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Financial regulators across the globe are turning up the heat on cybersecurity and clamping down on firms that fail to reach the standards. The SEC, for example, recently brought its first cybersecurity related enforcement action against an investment adviser for inadequate policies and procedures, as well as compromising the personally identifiable information of its clients and contacts.

It is not surprising therefore that our Global Regulatory Outlook 2016 shows the financial services industry expects cybersecurity to take its place as a top priority for regulators. In total, 19% expect it to be the number one priority for regulators in 2016, against 18% for AML and KYC requirements, and 15% for efforts to ensure a firm-wide culture of compliance.

With an array of guidance published, it's difficult for many firms to grasp what is the right thing to do to protect their clients, data and assets. In a world where a large cyber defense investment is no guarantee that a security breach would still occur, what exactly is it the regulators expect?

While regulators acknowledge that not all cybersecurity risk can be removed, what's clear is that they expect firms to anticipate potential cybersecurity incidents, rather than just reacting to breaches as they occur. Equally, a review of internal cybersecurity measures, policies and procedures, as well as those of service providers, is expected.

Many firms have responded by installing solutions without conducting a risk assessment upfront. As such, they haven't always understood the nature of the threats at hand, or the actual vulnerabilities in their systems – both internal and external.

The lack of a risk assessment can have worrying implications. First, without an audit trail, regulators will not be confident in the company's efforts to review and reduce the risk of cybercrime. Second, it could lead to a disproportionate response, with firms investing in expensive and extensive cybersecurity solutions to counter relatively small risks – or worse, vice versa – or inadequate cyber security policies for example.

Firms may also place too much emphasis on just part of the problem – the much publicized threat from external hackers, for example. Internet gateway defense has become the only focus of many cyber strategies, with internal risks not receiving equal attention and therefore remaining undetected. Cyberattacks frequently exploit existing vulnerabilities in a security system. Such information is often supplied to external hackers by rogue employees or ex-employees with a grudge against their previous employer. Data theft by a firm's own staff is a further often invisible potential hazard.

### Governance

So how can financial services organizations ensure their cybersecurity strategies have the necessary rigor?

Governance is the place to start:

- Establishing responsibility for cybersecurity and the reporting of risks and installed measures is highlighted at the board level
- Implementing an Information Systems Security Program (ISSP) (as termed by the NFA) that ensures cyber risks are reviewed and mitigation measures address the high risk areas. The program must include an effective cyber response and response plan. Also included would be any strategy to outsource certain cyber security elements to reduce risk

- Financial authorities around the world expect to see that governance structures for cybersecurity have been implemented, risk assessments made, and reports presented to the board
- Escalating cybersecurity to the directors of the organization will achieve more than simply pacifying regulators. Security risk mitigation investment which would not normally be prioritized in a budget cycle would, as a result of escalation, receive the attention it deserves

### Best practice

A key element of your ISSP is to conduct a comprehensive Threat and Vulnerability Risk Assessment (TVRA) – a type of analysis already enforced by the Monetary Authority of Singapore.

A TVRA will help:

- Identify relevant internal and external threats to your business
- Identify and protect confidential data
- Prioritize risks
- Shape appropriate security and response strategies
- Invest appropriately in the right defenses
- Meet regulatory expectations

The majority of security issues can be resolved relatively easily through quick, inexpensive preventative measures. For example, this would include introducing information security policies, blacklisting certain email and web addresses, and providing employees with adequate cybersecurity training.

Seeing cybersecurity as more than a technological problem is important. Network penetration testing, intrusion detection and network vulnerability scanning may all have a role to play. Such tools may be part of the solution depending on the size of network and computing facilities. An ISSP will ensure the basic and appropriate elements are implemented and investment is therefore not wasted.

Guidance from regulators is being updated on an ongoing basis, but firms clearly need to act now. To avoid falling foul of regulators, and to prevent serious damage to their businesses, firms must urgently assess their cybersecurity approach, and implement effective plans and policies to prevent, detect, and respond to cybersecurity risks.

**Dörte Höppner**  
Chief Executive  
Invest Europe

## COMMENT

*“European policymakers must maintain momentum towards the creation of a Capital Markets Union that strengthens the whole economy by promoting a wider range of funding options for companies, and creates a single European market for capital. Barriers to raising capital in some EU states must also be removed, while reforms to international tax rules in response to governments’ concerns about erosion of the tax base and profit shifting must not impede cross-border investing.”*

## Pricing Magic? Now You See It... Now You Don't!



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“Now you see it... now you don't!” isn't reserved for the world of magic any more. The world today has become increasingly complex and while technology and a general push toward transparency has made many aspects of our lives easier, today's markets seem to find new ways to test well thought out and implemented valuation processes and procedures. One area where historically we've been able to have confidence in the reliability of “the system” or “the market” is around the pricing of Level 1 assets (actively traded securities).

Globally, we are seeing that a liquid security purchased in the past with a historical reliable public price might not be so reliable going forward. From June 29 to August 3, 2015, the Greek Stock Market was closed due to the country's well-publicized funding and liquidity challenges. While the Greek market declined 23% in value during this time, fortunately, the suspension of trading was a result of macro issues and was anticipated. Asset managers with holdings traded on the Greek exchange were able to plan, to some extent, for the lack of trading and therefore the lack of observable prices to value investments.

But disappearing prices are not always systemic; they can be isolated and unexpected. One of the most famous idiosyncratic historic delistings or trading suspensions was that of Lehman Brothers (delisted by the NYSE on Sept 17, 2008). Lehman's troubles were known for days and even weeks before the International Swaps and Derivatives Association had a special trading session on a Sunday relating to a planned Lehman bankruptcy filing later that day. Other delistings often come as more of a surprise – without the well-publicized issues such as those leading to Lehman's delisting.

Over the past few years, there have been delistings in China over frauds and accounting irregularities. Most recently, with the significant decline in the Chinese stock market, numerous securities' trading has been suspended by the government. Both a suspension and a delisting clearly create a pricing issue on the date of the event and thereafter, although the challenges to determine a reasonable fair value estimate can be very different. With a suspension, one might reasonably believe the available financial results for the company to still be a reliable input into the valuation process. In the case of a bankruptcy or fraud, the reliability of the investee company's financial results may be highly suspect.

Some have used a macro “index” approach to determining fair value when the underlying company is healthy, but the market is not open or trading has been suspended for reasons unrelated to the portfolio company itself. For example, some have used the movement in prices of ETFs or ADRs for the industry, country, and/or related securities as a basis for determining the fair value of the suspended securities. Such an approach may be acceptable, in certain circumstances, for a short period of time after the suspension of trading, but would likely not be appropriate over a longer term.

However, in the event of a bankruptcy or fraud-induced delisting, or when trading has been suspended for an extended period (more than a month or two), valuation becomes more difficult. Rather than using macro index indications of value, fair value must be determined using so called level three (unobservable) inputs. Such a valuation may be difficult as the level of confidence in financial information (especially in the event of fraud) is low and in the event of

bankruptcy uncertainty around the value of assets is compounded by the uncertainty around the outcome and timing of the bankruptcy process. In both cases, there is a secondary market for these interests, but pricing tends to be “opportunistic” and difficult to establish “willing buyer/willing seller” as is the premise under the “Fair Value” concept. Therefore, informed judgement combined with a rigorous approach to valuation is required.

Bottom line: investors that report the fair value of securities need to be vigilant in monitoring market conditions especially with respect to securities traded in markets or on exchanges where suspension could occur. In most cases suspended securities will need to be valued

using level three inputs and a market and/or income approach. Securities where trading has been suspended because of accounting irregularities, fraud or bankruptcy will likely require extra scrutiny in coming to a fair value estimate. Even when the underlying company is healthy, when trading has been suspended — such as for government policy purposes — fair value would be estimated similar to any other private, non-traded, entity.

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**Marc Towers**  
Managing Director  
Towers Fiduciary

## COMMENT

*“I sense regulators are generally focused on addressing appropriate risks. The concern is that various regulations are sub-optimal in terms of addressing those risks yet impose material costs and distraction on the industry. I would welcome review and refinement of regulations already in place, particularly around reporting requirements. Greater collaboration between regulators focused on improving consistency and increased cooperation between them is crucial to achieve this.”*

## Urgency Grows to Prepare for MiFID II



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Improving market conduct and combating market abuse remain key focus areas for regulators globally, as regulators push to have more comprehensive and accurate data about the markets for which they are responsible. Related to this, the level of fines imposed by regulators on firms for transaction reporting failures has escalated significantly recently. In the UK for example, the FCA imposed a £4.7m fine on a global investment bank in 2014 for failing to properly report over 29 million equity swap contracts-for-difference transactions; in 2015, another global investment bank was fined £13.2m for a number of transaction reporting failures.

The authorities will continue to invest in more advanced surveillance tools and more sophisticated techniques to help them identify and combat rogue trading. In Europe, regulators are markedly increasing the breadth and depth of data they will receive through the introduction of new transaction reporting regulations under the Markets in Financial Instruments Regulation (MiFIR) and the Markets in Financial Instruments Regulation Directive (MiFID II).

MiFID II will drive fundamental changes in the EU securities markets and it is expected that no business operating model will remain unaffected. The scope will be extended from the current MiFID I requirements to include all financial instruments traded on all Regulated Markets, Multilateral Trading Facilities (MTFs) or the new Organised Trading Facilities (OTFs). When taken together with the new obligation to trade a much wider range of instruments on regulated trading venues, MiFIR will require investment firms to report virtually all their OTC fx, commodity and interest rate derivative transactions, in addition to the current requirement to report trades in listed equities and fixed income.

Not only is the range of financial instruments for which reports have to be made widening significantly, the detail that each report must contain is also much greater than MiFID I. The number of fields to be completed in each report has more than doubled and will now contain information such as the personal details of the individual making the trading decision, identification of the specific algorithm responsible, whether a pre-trade transparency waiver was used and if the trade was a short sale.

The increased scope will also have a global reach impacting non-EEA investment firms operating within the EEA or branches of EEA investment firms located in non-EEA jurisdictions that trade in reportable financial instruments. For example, the US branch of a bank authorized in the UK or the London branch of a Japanese bank authorized in Japan would both have obligations under MiFID II when they trade in reportable financial instruments.

Regulators are also preparing for the increased scope and scale of transaction reporting under MiFID II. In the UK for instance, the FCA is building an entirely new transaction reporting system in order to be ready for MiFIR implementation.

Despite the potential deferral of the MiFIR/MiFID II effective to January 3, 2018, the scale and complexity of changes will make it a major challenge for firms. Not only will it be one of the most complex compliance exercises undertaken to date, it will also require firms to consider its strategic repercussions upon their business and operating models. Non-compliance with transaction reporting requirements and a lack of governance, systems and controls to mitigate transaction reporting failures will continue to be scrutinized closely by regulatory authorities and action will continue to be taken against firms which neglect their responsibilities.

## A Greater Focus on Individual Accountability



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While some countries have embedded individual accountability in their supervisory mandates, the FCA and PRA in the UK have introduced dedicated regimes: the Senior Managers Regime, the Certification Regime and the Conduct Rules.

While the Senior Managers Regime was introduced to ensure senior managers are held accountable for misconduct that falls within their responsibilities, the Certification Regime and Conduct Rules aim to hold individuals working at all levels in banking to appropriate standards of conduct.

These regimes have the potential to be extraterritorial in impact and reach senior managers located outside the UK, especially for global financial institutions.

In the US, regulators have also increasingly focused on the oversight of key personnel within a financial services organization. The Department of Justice issued the Yates Memorandum in relation to individual accountability for corporate wrongdoing on September 9, 2015.

European countries, such as Germany, have also taken actions. Under the German Stock Corporation Act, board members are jointly and severally liable for breaches of their directors' duties under German corporate law unless they can demonstrate they acted with due care and skill.

### What is the industry's view?

This year's survey respondents remain mixed about the impact of individual accountability – 35% believe it will negatively impact the industry, compared to 32% who feel it will bring positive benefits. Furthermore, 34% believe increased accountability will deter prospective talent, 28% disagree. However in the UK, where the Senior Managers Regime has gone further than elsewhere in defining how regulation may enforce such accountability, 44% agree that it will deter prospective talent (against 33% in the US and 20% in Hong Kong).

What is clear is that regulators must strike a balance in implementing accountability regimes. On the one hand, there is a need for rules to ensure senior management functions perform effective governance and oversight, and improve professional standards and culture within the financial services industry. On the other hand, overly strict rules impose unfair burden and liability to senior managers who take reasonable steps to prevent and detect problems, and ultimately may deter qualified individuals to take up senior roles.



**Author**

**The Lord Flight**

Member of the UK House of Lords and the Lords Select Committee for Delegated Powers and Regulatory Reform

# The New Senior Managers and Certification Regimes

The Senior Managers and Certification Regimes were introduced by the Financial Services (Banking Reform) Act 2013, with the objective to install a regime which delineates and defines responsibility.

The Bank of England Bill extends the regimes to all firms in the financial services industry covered by the Financial Services and Markets Act 2000 (FSMA). The recent HM Treasury document “Senior Managers and Certification Regimes: extension to all FSMA authorised persons” sets out further details.

The original intention was for the regimes to include a “guilty until proven innocent” provision but this has now been dropped, particularly, following comment by the head of the Prudential Regulation Authority (PRA) that “guilty until proven innocent” would never stand up in a Court of Law. The new structure was originally for the banking industry but it has now been extended across the entire financial services industry, replacing the Approved Persons regime. It has both conduct and remuneration implications for those affected.

The key features are:

- An approval regime focused on senior management, with requirements on firms to submit robust documentation on the scope of those individuals’ responsibilities
- A statutory requirement for senior managers to take reasonable steps to prevent regulatory breaches in their area of responsibility; a requirement on firms to certify as fit and proper any individual who performs a function that could cause significant harm to the firm or its customers, both upon recruitment and annually thereafter
- Power for the regulators to apply enforceable Rules of Conduct to any individual who can impact their respective statutory objectives



The Senior Managers Regime is narrower than the Approved Persons regime, catching fewer people. Beneath it, the Certification Regime covering Material Risk Takers, is broader than the Approved Persons regime, catching more people, and is split into three categories: European Banking Authority defined as Material Risk; PRA defined as Material Risk Takers and Financial Conduct Authority (FCA) specifying "Significant Harm" Material Risk Takers, who provide advice to customers.

### Focus on Senior Managers

Under the Senior Managers Regime, individuals will require prior regulatory approval before performing their roles, although those in place are grandfathered. Senior managers will be subject to an annual internal review to confirm whether the regulator has grounds to withdraw approval of an individual. If so, firms are to notify the regulator accordingly.

Various prescribed responsibilities are allocated to senior management functions, leading to an individual's statement of responsibility and the firm's responsibility map. This allocates clear accountability to particular individuals. Handover certificates are required where senior managers move roles to ensure appropriate accountability.

Additional conduct rules require senior managers to take reasonable steps to ensure compliance with the business areas for which they are responsible. The regime provides for criminal liability for reckless decisions leading to the failure of a bank. Remuneration requirements apply

where a bank is at or above Level 2. The limitation period for disciplinary action by a regulator is extended from three to six years.

The responsibilities of senior managers are prescribed by the regulators and must be apportioned to individuals holding senior manager functions within a firm. Typically for a bank there are approaching 30 prescribed responsibilities.

The Senior Managers Regime covers the CEO, CFO, CRO, Director of Internal Audit, head of key business areas, Group Entity Senior Manager, Chairman, Chairmen of the Risk Committee, Audit Committee and Nomination and Remuneration Committee, Senior Independent Director, Compliance Officer and Head of MLRO. Only Non-Executive Directors (NEDs) who chair committees are covered by the Senior Managers Regime. Other NEDs, referred to as nominated NEDs, are not subject to either the Senior Managers or Certification Regimes but remain subject to the general law of the land.

Typically, the CEO will have prescribed responsibility for the firm's performance to its obligations under both the Senior Managers and Certification Regimes. Firms will need to submit their Senior Managers Regime and Certification forms to the PRA/FCA in January, but the UK Treasury has stated that it expects the changes to come into full operation in 2018. Banks with total assets under £50bn will not need to apply the rule obtaining to retained shares or other instruments, reward deferral and performance adjustment.

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**Ian Cornwall**  
**Director of Regulation**  
**The Wealth**  
**Management**  
**Association**

## COMMENT

*"Regulators and policy makers need to carefully consider the impact of continuous regulatory change. Firms, large and small, have finite resources and at present, and for the next year or so, key staff from across our member firms' businesses are having to focus on implementing a raft of regulatory changes. Firms want to improve their existing service offerings and develop new services but are constrained by doing so because the regulatory agenda, with set deadlines, dominates firms' activities and absorbs their internal resources."*

### Areas of the Certification Regime

The scope of the Certification Regime covers anyone who is considered a Material Risk Taker, including:

- Staff who are members of the management body and its management function
- Heads of material business units
- Staff with managerial responsibility in the independent risk management function, compliance function or internal audit function and who report directly to the head of that function
- Staff with managerial responsibility in a material business unit, reporting directly to the head of that unit
- Staff heading a function responsible for legal affairs, finance, including taxation and budget, Human Resources, remuneration policy, information technology and economic analysis
- Staff responsible for, or a member of, a committee responsible for the management of a risk category, other than credit risk and market risk

The PRA also requires in the Certification Regime those individuals carrying out activities which enable them to expose the firm to a material level of harm, even if these individuals do not fall within any of the mandatory criteria.

### Adjusting to the new reforms

The new SM and CR represent the furthest reaching reforms the UK Government has made on the personal responsibility of senior managers in the financial services industry, intended to ensure they face the same “duty of responsibility” in whatever type of firm they work.

The new regime is, essentially, the result of the concerns raised by the Parliamentary Commission on Banking Standards over the Approved Persons Regime. Importantly, the Bank of England and Financial Services Bill amends the definition of “misconduct” applicable to senior managers so that where there has been a regulatory contravention in an area for which they are responsible, senior managers no longer have to prove that they have taken reasonable steps to prevent contravention to avoid being found guilty of misconduct. Instead, it will be necessary for the regulators to prove that a senior manager has not taken such steps before they can bring such disciplinary proceedings against them.

The new arrangements have been broadly accepted by the banking industry as providing necessary personal responsibility and accountability for senior managers, as well as a more effective and proportionate means to raise standards of conduct of key staff more broadly. Its potential weakness is being over prescriptive and not requiring overall principles of acting at all times in good faith, with integrity.

Banking is, however, a special case “industry” as ultimately it can require taxpayer support. It is yet to be seen how the application of the SM and CR will apply to other areas of the financial services industry where the case for its application is less compelling. The new regime will cause a major increase in operating costs and is likely to render small scale business unviable. NED fees are already increasing in reaction to the increased responsibilities.

I do not see the new regime fitting well for the investment management or insurance industries.

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**Guy Sears**  
Interim Chief  
Executive Officer  
The Investment  
Association

## COMMENT

*“Focus on the savings ratios, capital raising, the integrity of the markets and improved productivity, so as to foster a competitive and innovative environment that serves investors and issuers.”*



# ENFORCEMENT AND FIRM VULNERABILITIES

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**Author**

**Richard Weber**

Chief of the Criminal Investigation Division  
Internal Revenue Service

## A Focus on Criminal Investigations

I am incredibly honored to be the Chief of the Internal Revenue Service's Criminal Investigation (CI) Division for the last three and a half years. CI investigates potential criminal violations of the Internal Revenue Code and related financial crimes such as tax-related identity theft fraud, money laundering, cyber-crimes and terrorist financing that adversely affect tax administration.

Using our unique statutory jurisdiction and financial expertise, we make significant contributions to important national law enforcement priorities and are routinely called upon to be the lead financial investigative agency on a wide variety of financial crimes. Working with the 94 United States Attorney's Offices all across the country, we boast the highest conviction rate in federal law enforcement (93.4%) and are known as the best financial investigators in the government.

For as long as Americans have been paying taxes, criminals have been trying to find new ways to avoid paying them. But criminal methods and

schemes have evolved and CI special agents have had to evolve with them in order to combat their increasingly sophisticated financial crimes. One of the most significant examples is the identity theft problem. CI has been on the front lines in the war against identity theft, especially when individual identities are stolen with the intent to file false returns claiming tax refunds. CI has also recently been involved in a significant number of investigations involving data breaches that impact tax administration. Data breaches, in which personally identifiable information is stolen, can result in the filing of false income tax returns.

In fiscal year 2014, CI initiated 1,063 investigations related to ID Theft and recommended 970 for prosecution. More than 18% of our direct investigative time was devoted to ID Theft investigations in both fiscal years 2013 and 2014. The sophistication of Stolen Identity Refund Fraud (SIRF) crimes should concern you. Today's cyber criminals are well organized and have turned SIRF into a profitable business using encryption and anonymizing services to avoid detection. Criminal services are advertised on the Dark net where one can buy and sell stolen identities, user names and passwords. Virtual currency further disguises flow of illegal funds. Let me be clear, both public and private sectors are targets for data breaches. Combating this crime is resource intensive, but it is a fight we must win. It is estimated that at least half of the adult population in the United States has already been impacted by ID theft.

Recent investigations have specifically traced at least \$26m of the criminal profit to cash outs occurring in Nigeria, Russia, and Eastern European countries such as Bulgaria, Romania, and Latvia. SIRF presents a threat to tax administration because it can fundamentally undermine the principles of fairness and integrity that underlie the voluntary compliance system, particularly when taxpayers who want to meet their tax obligation cannot.

Although we have made progress in combating ID theft, we have significant challenges ahead. IRS CI has made fighting ID theft, refund fraud, and cyber-crimes that impact tax administration a top priority and we will continue to collaborate with other federal, state, and local agencies with a common interest. A number of extremely successful ID theft "filters" designed to catch and stop identity theft returns have been implemented due to CI's investigative work and its strong relationships in the law enforcement community.

We continue to collaborate with private sector partners to promote awareness and reduce vulnerabilities. We recently stood up a new Cyber Crimes Unit based out of our Washington, DC Field Office devoted to investigating these types of crimes. This is not a fleeting problem, however, but rather one that will be with us until we are able to more effectively protect our personal information. I encourage you to work with us in new and innovative ways. Public-private partnerships are key sharing best practices and working together to create relationships that are helpful to all of us.

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**Mikael Down**  
**Director of Policy**  
**and Analysis**  
**Banking Standards**  
**Board**

## COMMENT

The Banking Standards Board aims to raise standards of competence and behavior across all banks and building societies doing business in the UK. One theme we will explore in 2016 is professionalism, which was a key focus both for the Parliamentary Commission on Banking Standards and in Sir Richard Lambert's Banking Standards Review. We will be engaging with member firms, professional bodies and others to examine how qualifications are used across the sector; whether and how this is changing in light of the Senior Managers and Certification Regime and other developments; and whether it would change if the qualifications were different.

## AML and Sanctions Compliance Remain a Priority



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AML and sanctions are areas of great complexity and constant change. Numerous high-profile enforcement actions definitively show that AML and sanctions compliance remains top priorities for regulators and law enforcement. In recent months, the US Government has explicitly stated it will focus intensely not just on what it sees as institutional lapses and malfeasance, but also on individual acts and liability. Furthermore, Duff & Phelps' Global Enforcement Review 2015 shows a global trend of an increasing tendency of regulators to focus on individuals, both through criminal sanctions and civil fines.

Criminal and regulatory enforcement actions in these areas have resulted in multi-billion dollar fines and criminal liability. But it's not just the massive, head-line grabbing cases that demand attention. Smaller, though still significant, actions show that financial services businesses are being closely scrutinized. Moreover, unregulated corporate entities are also open to financial crime risk through the enforcement of sanctions, corruption or other criminal laws.

While it remains to be seen how the stated focus on individuals will play out, there can be no doubt that in this climate, financial controls, including robust AML and sanctions programs, are critical to effectively managing risk. Emphasis on the importance of these areas should come from the highest organizational levels. In one public statement after another, regulators stress that they expect management to set the proper tone – to demonstrate that compliance matters.

Today's AML compliance regime reflects influences that technically come from outside the AML sphere - most notably, the threat of terror finance. Although distinct from traditional money laundering, it nonetheless has a significant impact on today's money laundering enforcement regime. In fact, the threat of terrorism is what initially fueled the tremendous changes in compliance expectations for banks. Other influences are the significant sanctions, anti-bribery and corruption cases brought by law enforcement in the past several years.

In this context, AML compliance programs must do more than just identify money laundering. They must be holistic in their approach to detect financial crime. Such programs must be designed to take into account suspicious money movements that may indicate a whole host of crimes: corrupt payments, including bribery, human trafficking, and narcotics trafficking; securities fraud and Ponzi schemes; and other fraudulent schemes. In fact, programs will be evaluated by regulators with diverse areas of focus: securities fraud (SEC, FINRA and FCA); financial crime and money laundering (FinCEN, FCA and law enforcement); and institutional safety and soundness (functional regulators).

Of course, the ultimate goal here is not just to respond to regulatory concern. It is to prevent crime, protect against reputational risk, and avoid the massive cost incurred when institutions are used by bad actors to commit, fund, or hide the proceeds of crime.



## No Rest in the Fight Against Market Abuse



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The Global Regulatory Outlook shows that market abuse was not the highest priority on the industry's list of where they expect regulators to focus in 2016. Just 4% named manipulative trading strategies as a key issue in the coming year, for example. Fewer still, 3%, named benchmark manipulation.

It is certainly true that regulators have a lot on their plates, and it is difficult to fault the industry's view that key focus areas for regulators in 2016 will be on cybersecurity, AML and culture. However, changes coming into force in July with the European Market Abuse Regulation (MAR) and with MiFID II will also have a dramatic impact on the market abuse and reporting regime. As a result, regulatory scrutiny on market abuse is bound to intensify.

Through our experience of working with the industry across the globe on this area, it is evident that not all firms are prepared for these fundamental changes.

### Wider reach

In short, MAR will see market monitoring requirements intensify with higher expectations applying to more asset classes and market participants.

The regime will harmonize market abuse rules across Europe and see them apply not just to equities, and debt but to commodities, FX, interest rates – and all related exchange traded and OTC derivatives. Moreover, MAR tends to mirror the transaction reporting rules, also revised with the introduction of MiFID II. As a result, trading on exchanges outside the EU will be caught by the rules if the instrument they are trading is a derivative of an underlying asset traded in Europe.

Fundamentally, the regulations make clear that market abuse is not simply an equities problem. They also expand the range of activities firms must monitor: as well as insider trading and unlawful

disclosures, MAR also prohibits order activity – covering situations in which inside information is used to avoid losses by cancelling an order, for example. Suspicious transaction reports (STRs) are to be replaced with suspicious transaction and order reports (STORs).

What's clear, however, is that an integrated approach across the business is needed to combat market abuse; no longer can this be seen as only a compliance issue for example. Regulators are also increasing or enhancing their expectations on firms to actively police the market – in the UK for example, the Senior Managers Regime as well as the possibility of market abuse risk assessments becoming a requirement is evidence of this.

### Time to focus

Firms will need to be particularly alert to the new regulations as well as regulators' changing attitudes to enforcement.

Those firms include all those involved in high frequency and algorithmic trading; after all, the regulations are in part designed to address developments since the Market Abuse Directive in 2005. Firms are expected to monitor trades routinely, and MiFID II stipulates the time within which alerts from their market monitoring system should be ready for review. The buy-side, too, can expect increased scrutiny. Indeed, buy-side firms are already hiring specialist expertise and implementing automated systems to look for market abuse.

More generally, as tough action against individuals shows, there is little sign of regulatory attention and investigations slipping. With significant evidence also suggesting some practices such as layering have been looked on by many in the market as legitimate trading strategies, some firms face a race against time to change their behavior before it's too late.

## Getting to Grips With a New Enforcement Reality in France



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France's investment community is facing a tougher approach to enforcement from the country's financial markets authority.

Introduced in 2013, the Autorité des Marchés Financiers' (AMF) new inspection regime is placing significantly more demands on investment management firms and their compliance functions.

**A new approach**

The updated regime is becoming more onerous in a number of ways. The AMF has historically sanctioned firms for violations or non-compliance relating to market abuse issues or breaches of fiduciary duties to clients. More recently and with greater enforcement powers, the AMF is stressing the need for firms to comply with the whole rule book. Firms have been sanctioned for compliance procedural and operational transgressions that are absent of any breach of fiduciary duty or evidence of market abuse. These include a lack of formal contracts with external compliance providers, or insufficient control over their work.

UCITS fund management companies have also been reported for persistent breaches of regulatory ratios as evidence of: failing to have in place necessary compliance resources and controls; insufficient monitoring of regulatory ratios and risk management conducted with tools provided by the fund administrator; and the absence of an in-house risk management framework for monitoring investment restrictions.

The AMF also provides no advance warning of inspections. It can request access to the email accounts of selected individuals, which must be produced in a timely fashion. Inspections are now also conducted off-site, leaving little prospect for constructive dialogue between inspectors and investment managers, and in some instances leading to longer inspection.

Significantly, the Commission des Sanctions still generally publishes its decisions, no matter how small the breach, with most naming the investment manager and staff.

**Proactive measures**

The conclusions of the AMF's inspection will determine whether a firm is put forward for a sanction or settlement agreement, so it is imperative investment managers take steps to prepare for an inspection.

Their first priority should be to establish a dedicated inspection team, tasked with being the primary contact point with the AMF and preparing, supporting and guiding the firm through the inspection process. During the inspection itself, the team should manage the information flow in response to inspectors' requests. This entails checking the accuracy and completeness of the information provided, as well as ensuring that all deadlines established by the AMF, which often become tighter as the inspection moves forward, are met.

Any employees called before the inspectors will need to be fully briefed by the inspection team, and given access to the necessary information. This is particularly important if they're not part of the compliance department.

The team must also be ready to spot any areas that suggest inspectors may not fully understand aspects of the firm's business. It is vital to correct false assumptions as early as possible during the inspection process and not wait until the report phase.

There are also legal considerations to consider when seizing email accounts, particularly as communication exchanges which would otherwise be covered by legal privilege will be accessible. Firms should have it noted in the minutes of the initial inspection meeting where staff members are waiving legal privilege when handing over their email accounts.

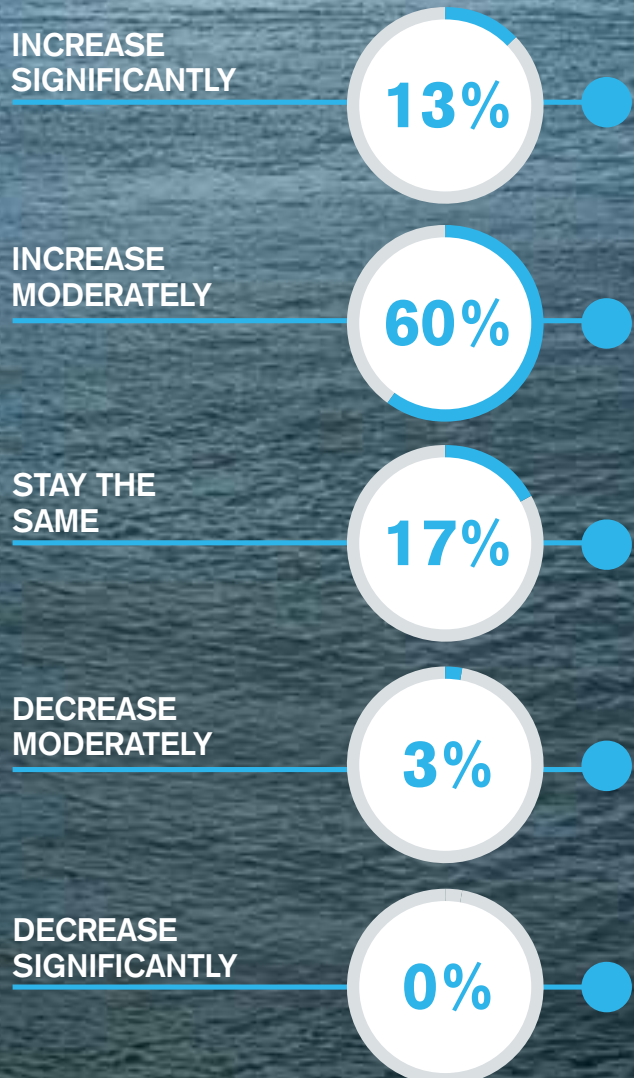
Finally, firms may also consider using external experts as part of their annual compliance strategy to run mock inspections, and highlight any compliance 'gaps' or areas for improvement. They can also guide businesses through the inspection process itself.

The new regime can be a drain on resources, creating challenges for the performance, profitability and competitiveness of French investment management companies. But with the right measures in place, businesses should ultimately have little to fear.



Figure 3 - DO YOU EXPECT THE NUMBER OF REGULATORY ENFORCEMENT ACTIONS IN 2016 TO:\*

\* Note: the figures do not include respondents who selected "Don't know"



## Testing Times: Preparing for an SEC Exam



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On average, the SEC examines 10% of registered investment advisers each year. While still relatively infrequent, this means an exam will come sooner or later for most firms.

In fact, preparation must begin sooner – certainly long before the CCO is notified of an examination. The attributes regulators look for – relevant, robust and up-to-date compliance policies and procedures, strong internal controls, and a culture of compliance – take time, effort and resources to develop. If they are in place, the firm will be in a strong position to tackle the examination.

From the start, it is important to set the right tone with the examiners. From the first interaction, the CCO should be professional, responsive and cooperative. Again, this requires preparation; it means, for instance, being able to respond timely and completely to the SEC document request list. Key compliance, accounting and investment records should be readily accessible, of course, but requests may also encompass documents such as historic emails – a particular challenge if systems are not geared up for it.

Employees at the adviser should also be well prepared to participate in the examination. Mock exams, including interviews with key employees, are a valuable preparation tool for the firm. It is not a question of coaching staff to give the right answer, but rather creating the experience of presenting and explaining what they do on a daily basis and how those activities relate to the firm's internal compliance controls. Besides helping to prepare for a SEC examination, performing a mock exam that includes forensic testing and employee interviews also serves an important role in building and maintaining a culture of compliance. Employees take notice when a firm invests in its compliance program.

Finally, it is important to take into account both the firm's unique requirements and the SEC's broad regulatory concerns. On the one hand, an adviser must demonstrate that its compliance program is tailored to address its specific risks. Most obviously, if deficiencies were identified in a previous regulatory exam, the CCO should be able to demonstrate how these weaknesses were remedied and how the firm continually monitors to mitigate them from occurring again. More generally, boilerplate compliance policies and procedures will immediately set the wrong tone with the regulators.

On the other hand, the firm's priorities must take into account those of the regulators. Keeping abreast of the SEC's communications, and evaluating and adopting responsive measures, will assist the adviser in demonstrating it implemented an effective and thoughtful compliance program. Knowing that the SEC is particularly focused on cybersecurity, for example, will enable a firm to ensure these issues are explicitly addressed. An adviser that not only has a strong compliance program but can also demonstrate how it actively addresses the SEC's priorities will strike the right tone with the regulators at the start of an examination.

Fortunately, the areas that the regulator is focusing are no secret, and successful CCOs will ensure they regularly review these. In this respect, the SEC examination priorities published on their website are a good place to start.

## Financial Crime Compliance: Beyond Banking



### Author

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Regulatory actions continually show that expectations of a corporate 'culture of compliance' or mindset must be evident across all lines of business, particularly the revenue generating lines engaged with deal making, sales or clients. This has been a steady theme within banking institutions for years, but expectations are increasing for non-banking financial sectors and corporations in other sectors to adopt a similar approach – particularly to minimize financial crime risk.

### Compliance and financial crime

The FCA's recent enforcement action against a global bank illustrates the shift in regulatory focus. In this case, the FCA levied a fine of \$109m against the institution, the largest FCA fine ever brought for financial crime regulatory shortcomings. Significantly, the underlying action did not involve allegations of illicit funds movement or actual financial crime, but instead accused the firm of willingly subverting normal due diligence processes in pursuit of profit.

What drove the record fine was an insufficiently embedded and prioritized culture of compliance and the risk this posed, as opposed to actual facilitation of, or willful blindness to, financial crime. The FCA also observed that customer facing entities within the bank (the deal makers) were willing to place profit before compliance, and did not ensure that compliance personnel performed proper compliance risk reviews.

In December 2015, the New York State Department of Financial Services proposed a rule requiring Chief Compliance Officers (or equivalent) to personally certify annually that their institution is maintaining sufficient AML, sanctions transaction monitoring and client screening systems. This rule covers hundreds of institutions, including more than one hundred foreign institutions that operate a branch or representative office in New York State. The Department specifically cited a "lack of robust governance, oversight and accountability at senior levels" as having contributed to recent enforcement actions.

### Expectations in other industries

This expectation is also increasingly demonstrated within non-banking financial institutions, particularly in the US. In August 2015, FinCEN proposed that obligations imposed by the Bank Secrecy Act for reporting of suspicious activity and recordkeeping should be extended to SEC registered investment advisers.

By placing advisers under this regime and providing civil safe harbor for reporting suspicious activity by their clients, registered investment advisers will be required to adopt new policies and implement new processes. Most importantly, it will also compel advisers to report activities or statements of their clients where reasonable suspicion of illicit activity exists. For some firms, this will constitute a significant change in their compliance mindset.

Finally, increasing regulatory expectations in corporate sectors beyond finance are tangible. In 2013, a European-based oil services company paid \$253m in fines and penalties, with three subsidiaries pleading guilty to violations of the FCPA and US sanctions laws.

Compare this with cases in 2015 involving the conviction of a software company executive for FCPA violations, as well as guilty pleas of the CEO and two other senior executives of a BVI-based oil and gas company. Despite the senior executives being involved in the violations, the US Department of Justice declined to prosecute the companies, citing self-identification, strong cooperation and the existence or development of strong internal compliance governance structures as mitigating factors.

Firms across sectors therefore would be well advised to ensure a compliance governance structure and mindset is implemented within their organizations.

# INDUSTRY COMPETITIVENESS AND REGULATION

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**Author**

**Sharon Bowles**

The Baroness Bowles of Berkhamsted

Member of the House of Lords, Member of the European Parliament from 2005 to 2014 and chairwoman of the Committee on Economic and Monetary Affairs from 2009

# No Rest for Financial Services Regulation in the European Union

The ebb and flow of European financial legislation can be missed by those not avidly following public affairs.

The five years in which I served as Chairwoman of the European Parliament's Committee on Economic and Monetary Affairs (ECON) were exceptionally busy. The committee oversaw more than 40 different pieces of financial services legislation.

In the cycle of things, after this burst of legislative activity there is now a lull. For banks, asset managers, insurers and national regulators, it may not feel that way, however.

EU legislation is sometimes criticized for being more detailed than its equivalents in the US, such as Dodd-Frank, but that is not the full story. The complexity of financial regulation means that the legislative process is followed by a significant period of detailed rule making before implementation. The US and other countries do this too, but as single countries their regulatory agencies have greater flexibility to decline to enforce provisions that would be detrimental in practice.

Meanwhile, the European legislature is enjoying some breathing space. Those tasked with interpreting and implementing legislation already passed, on the other hand, continue to feel the pressure.

Continuing efforts to define and calibrate leverage ratios under the new bank capital rules are underway. Rulemaking on MiFID II is throwing up tricky problems with delay until 2018 countenanced. There is a long pipeline of other issues, from Solvency II for insurers, to Regulations on European Long Term Investment Funds and the Deposit Guarantee Scheme.

Although nothing will ever compete with the post crisis global regulatory flood, the financial services legislative program in Europe will soon restart.



Financial services firms should embrace this, rather than fear it. Some of it may be what they have been asking for: European commissioner Jonathan Hill is conducting an overall review of how the recent legislation interacts and where tweaks may be needed. Seeking and mending mistakes is a European work-in-progress.

### Looking ahead

The next big project in Europe is capital markets union, the proposals of which are already being put forward. As Commissioner Hill has pointed out, small and medium sized countries raise five times as much funding from capital markets in the US as in the UK.<sup>11</sup> Addressing this will require some legislation. Largely, the changes should enable business rather than restrict it, helping simplify cross-border investment flows and reducing national barriers and costs.

As ever, the European Parliament can play a key role in shaping legislation, and those in financial services must continue to work with it to ensure

workable, effective regulation. ECON has shown its effectiveness in the past on a host of issues as well as attention to follow-on detail. Its rejection of the EMIR Regulatory Technical Standards in 2013 won concessions for smaller market participants and on collateral requirements, preventing harm to the economy and ensuring the use of derivatives for hedging would continue.

Not every idea that comes from the European Parliament is welcomed by the industry. Bonus caps was unpopular, hogging too much attention, but was unavoidable in the light of public opinion. Now the UK's own extended clawback has taken top slot as the most complained about!

For those that follow it, the European legislative process is largely transparent – more so than agreements determined in Basel. UK banks and others should continue to use that transparency in coming years to engage with the debate and make their voices heard.

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**Jack Inglis**  
**Chief Executive Officer**  
**The Alternative**  
**Investment Management**  
**Association (AIMA)**

## COMMENT

*"A common theme in recent reforms – AIFMD, Dodd-Frank, EMIR, MiFID II – is a massive increase in what hedge fund managers have to report to regulators. But it's clearly time to look again at the rules in a more holistic way: there's duplication, inconsistency, and a concern that regulators aren't really getting the information they need."*

<sup>11</sup> <http://www.ft.com/cms/s/0/b00f7b4a-66a0-11e5-a57f-21b88f7d973f.html#axzz3r7FY7pv>

## The Future of Cayman



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The European Securities and Markets Authority's (ESMA) recommendation in July 2015 that the AIFMD passport be extended to only Switzerland, Jersey and Guernsey at this stage caught many by surprise. That surprise quickly turned to disappointment for the Cayman Islands. Despite being a major offshore center for hedge funds, it was not among those countries to receive approval. Nor was the US recommended, even though European managers raise significant funds from US institutional investors through Delaware domiciled feeder funds.

The passporting regime allows non-EU alternative investment fund managers and funds in passported countries to be marketed to professional investors throughout the EU. Without it, alternative funds are stuck relying on individual EU members state's private placement regimes (PPR) that restrict the range of investors who can be targeted, and the rules of which vary from state to state.

ESMA has promised to further assess other jurisdiction, including the Cayman Islands and US, as well as Hong Kong and Singapore. The Alternative Investment Management Association has said it is confident the Caymans is well-placed to have a successful review in the "near future".<sup>12</sup> The Cayman Islands Government has also entered into cooperation and tax exchange arrangements under AIFMD with EU government and regulatory bodies, as well as developing an AIFMD compliant opt-in regime so its industry can capitalize on the opportunities in Europe.

This may seem a little optimistic, however. The official line from ESMA is that it didn't have enough information to approve the Cayman Islands at this stage. However, there is considerable opposition among some regulators to the Cayman Islands, whose regulatory regime is still perceived as too light in touch.

In any case, the date at which managers and funds domiciled there can hope to sell freely in the EU has now been substantially pushed back. Even the three countries approved by ESMA must wait for the EU Commission, Parliament and Council to approve the change. For others, while a review is promised, there's not a timetable yet in place. Currently the national PPRs are due to remain in place until at least 2018. If such significant homes such as the Caymans (and the US) are not passported by then, they could be in place much longer.

For many funds that have been stalling to see if the Cayman Islands would get its passport, the news could be the spur they need. Some funds may ultimately decide the costs and complexity of the European regulatory regime is not worth it. Some may look to relocate; certainly, the extension of the passport to Guernsey and Jersey should cement their position as leading domiciles for private equity funds.

Many others, though, cannot realistically relocate, yet will not be willing to write off such a huge potential market. Most of these, other than the very largest, are not equipped to become European-registered AIFMs, however.

For them, it seems likely that outsourcing to a passported management company or becoming an appointed representative of a European regulated firm are going to be the only viable options. Many are already taking this route, particularly through arrangements based in the UK, Ireland and Luxembourg. These options also present a number of additional benefits to firms including minimal start-up time, operating efficiencies, and oversight of local regulatory and compliance arrangements. ESMA's surprise announcement this summer means that in 2016, we will likely see many more firms make this move.

<sup>12</sup> <http://www.aima.org/en/media/press-releases.cfm/id/EF6EE637-F471-4D1E-BF926D3339CB0DEF>

## Costs Versus Return: Accessing US Institutional Investors



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Despite the difficulties for Chinese stocks in 2015, Asia remains a key asset to the world growth story. For example, according to The World Bank,<sup>13</sup> East Asia as a whole accounts for almost two-fifths of global economic growth, with expected growth of 6.5% in 2015. This makes the region an attractive alternative for US institutional investors looking to diversify portfolios following a six-year bull run on domestic equities.

Equally, US pensions, family offices, fund of funds, and other large institutional investors should be attractive prospective investors for Asia-based managers. However, to have a strong chance of winning US investors, Asia-based firms will likely need to enhance their existing compliance programs to meet US regulatory requirements, which may be triggered as a result of the manager accepting US based investors. Furthermore, to meet investors' expectations, mandates and their own comfort level in understanding SEC requirements, US investors may also require the Asia-based manager to register with the SEC before making an investment, even if an exemption from registration is available.

Clearly this has made it more challenging for Asia-based managers given the additional associated costs and burden of regulation under the SEC or CFTC, which can be seen as a barrier to accepting US investors. As identified in this report, the rising cost of compliance remains a significant concern for the industry, with the majority of survey respondents also believing regulation is creating a barrier to access new customers and geographies.

However, non-US managers should not give up on US investors too easily. The challenges can be overstated and benefits often overlooked. Although it can be argued that the regulatory requirements of the SEC are more stringent and more specific than those of many non-US regulators, the hurdle should not impede the manager's ability to access additional AUM.

Since many Asia-based managers already have some level of a compliance program and compliance function oversight in place or are regulated by another top tier regulator (such as Hong Kong's SFC or Singapore's MAS), the changes to meet SEC requirements are manageable. Furthermore, much of the required expertise can be sourced through external advisors, which can be more efficient than appointing and developing in-house expertise for global regulatory matters.

Costs are just one part of the equation as the upside for relatively smaller Asia-based managers is that a single allocation from a US institution can have a dramatic impact on AUM. Regulatory registration and oversight therefore should not be seen solely as a cost, but potentially a powerful competitive advantage.

<sup>13</sup> <http://www.worldbank.org/en/news/press-release/2015/10/04/growth-in-east-asia-pacific-likely-to-moderate-but-still-remain-solid-says-world-bank-report>

## Gaining an Edge From Compliance



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The Global Regulatory Outlook shows that 85% of respondents expect regulations to increase their compliance costs this year, and only 24% see that regulation can enhance their competitive advantage.

Spending in compliance can be justified by the potential consequences of failures. However, if firms around the globe want to see real change and genuinely effective procedures, compliance must evolve from being considered a cost center to a value generator. Firms have to buy into a positive case for compliance.

**Sticks...**

There is, of course, no shortage of ammunition with which to threaten firms and make the negative case for compliance.

Most obviously, the cost of compliance is still dwarfed by potential fines and penalties for regulatory failures. Multi-billion dollar settlements for major breaches reflect a broader trend of rising penalties. Duff & Phelps' Global Enforcement Review 2015 shows there is also an increasing tendency of regulators to focus on individuals, both through criminal sanctions and civil fines.

There are also consequences of compliance breaches, which are harder to measure. Firms with regulatory failings tend to find staff retention difficult and replacing lost staff costs firms in terms of both recruitment expenditure and business disruption. The effectiveness of risk controls can also impact firms' capital requirements. Moreover, reputational costs, though notoriously difficult to measure, cannot be discounted.

**...and carrots**

However, all of these incentives for compliance are not enough. First, despite the investments in compliance, regulators remain unsatisfied, and continue to call for cultural change from firms. Firms must move beyond mere lip service compliance.

Further, if firms focus purely on avoiding sanctions and the adverse consequences of regulatory breaches, compliance will only ever be reactive. Opportunities to realize benefits from a proactive, strategic approach will be missed. These benefits are as wide ranging as the risks firms face.

Savings from eliminating duplicated efforts and over-spend on compliance are among such benefits, as well as operational efficiencies arising from the implementation of seamless administration systems. They also offer the potential for better client servicing.

Embedding compliance tasks into front-line procedures can reduce delays in on-boarding new clients. Reducing the time spent on remediation as a result of oversight also frees staff to concentrate on growth.

Moreover, by integrating controls into the business so that compliance becomes second nature, businesses can more accurately monitor and manage their risks. Businesses can practice risk management rather than risk avoidance, and the compliance function can move from being the 'business prevention unit' to the business enabler.

Finally, it is worth considering that an examination of a firm's compliance framework will be an important part of any serious buyer's due diligence process. For those considering a sale in the future, an effective compliance regime will be central to achieving a good price.

**A long road**

Delivering such a transformation requires commitment, with requirements for significant changes to both client-facing teams and the compliance and control functions.

The former must learn to see compliance as more than mere box ticking, but rather an integral part of the business process. Staff must take ownership of risks and learn to be naturally curious, developing a sense of the issues that need to be escalated for checking with compliance. For the purposes of AML and counter-terrorist financing measures, it means cultivating an awareness of the high risk jurisdictions, sectors and businesses.

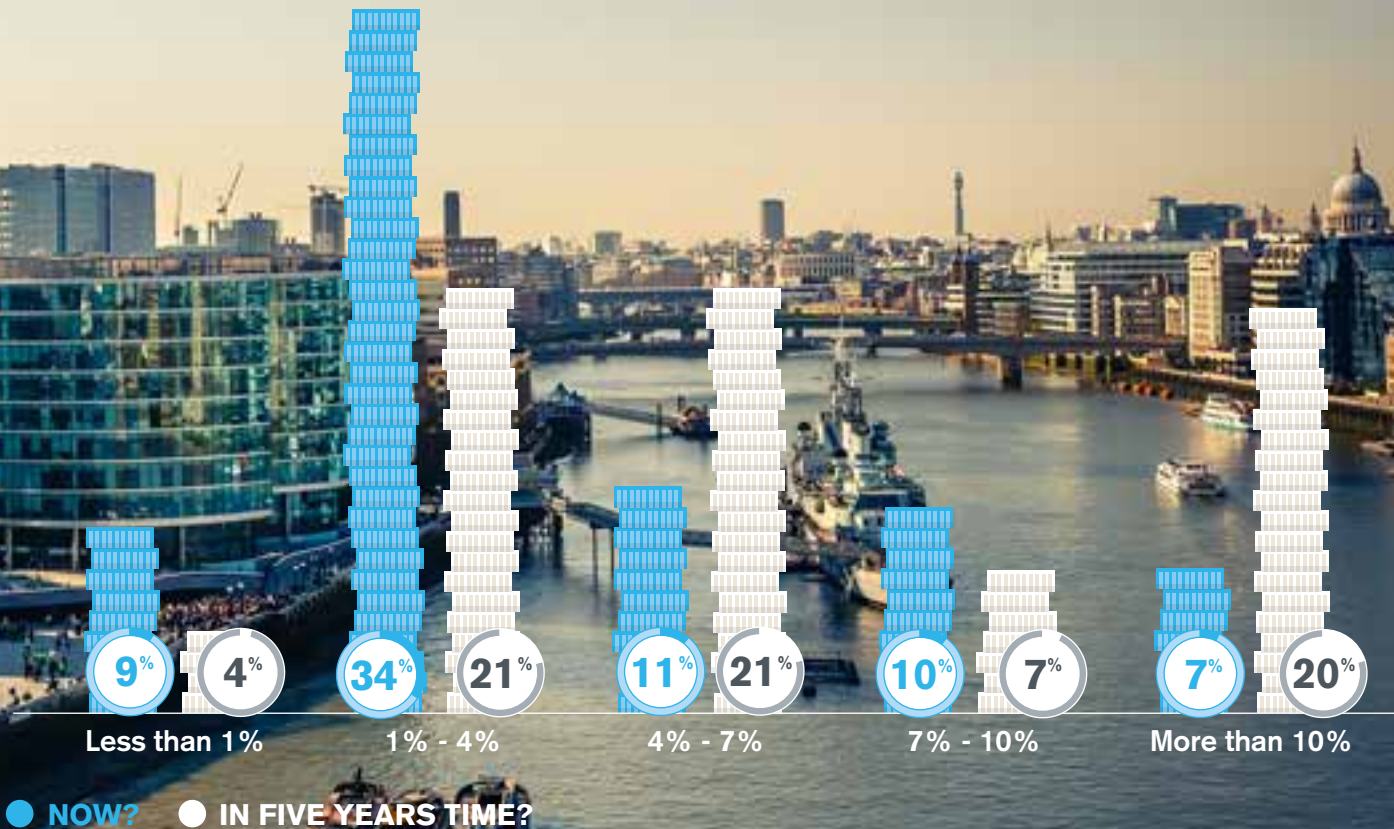
The compliance team, on the other hand, must drive through procedures that are effective, but also practical and commercially aware. Without that awareness, they will never gain the vital support of senior management.

Finally, managers need both quantitative and qualitative management information to be able to benchmark and track performance. Compliance staff attrition levels, regulatory visit findings, compliance breaches and self-identified issues need to be monitored alongside overall compliance costs. These should also be set in the context of profitability measures, as far as is possible: reduced capital requirements, reduced recruitment and staff retention costs and losses avoided, for example.

Only by setting out the benefits as well as the costs of compliance can firms begin to put in place incentives for a cultural transformation – one that regulators demand and that the industry should be seeking for its own sake.

Figure 4 - AS A PERCENTAGE OF ANNUAL REVENUE, HOW MUCH DOES YOUR COMPANY SPEND ON COMPLIANCE?\*

\* Note: the figures do not include respondents who selected "Don't know"





**Author**

**Peter Guy**

Editor in Chief  
Regulation Asia

# Regulatory Compliance and the Coming Financial Crisis

Excessive financial regulation could play a major role in precipitating the next global crash.

Financial compliance managers and regulators have been struggling to gain control over the entire banking system since the global financial crisis. Despite an avalanche of resources thrown at achieving a stable compliance regime, it has remained frustrating and elusive.

Worst of all, compliance officers privately admit that no one knows how to implement current reforms while new ones - both international and local - are being piled on. The situation will have serious consequences when the next financial crisis hits.

Regulatory changes are always emerging and they are event led. Banks can't look forward. They have no choice, but to react, which makes meeting compliance demands from competing jurisdictions an almost impossible set of shifting goalposts.

The reality is that financial institutions are completely bewildered and confused about how to implement new regulatory frameworks. The result is that bank managers and central bankers have become inward looking and focused on finding the next evil money launderer. The worst consequence is being unable to focus on how to protect themselves from the next financial crisis. And it could be just around the corner in 2016 as the US raises interest rates, global economies have slowed their growth and commodity prices continue to fall.

Banks and governments will have little maneuvering room for liquidity in the next crisis after eight years of quantitative easing and a towering US deficit. Think about this situation: after four quantitative easing programs - TARP, TGLP, HAMP, HARP - and direct bailouts of Bear Stearns, AIG, GM and bank supports totalling

more than US\$30 trillion, the US economy has only grown by \$954bn since the beginning of 2009 to 2013.

This equates to a miniscule 7.5% growth during the same time period as the stock market surged by more than 100%. This hastily constructed bail out comprised an avalanche of cash and a complicated web of global and local regulations to prevent private banks from experiencing another similar meltdown. The “too big to fail” banks have become “too big to save” and now perhaps “too big to regulate.”

What is within the power of central banks to fix and manage has already substantially diminished to the point that regulators are only worsening the situation with new rounds of demands for more compliance. The ready fix of a trillion dollar bailout isn't available the next time.

The ability of banks to handle the next crisis could be crippled because of excessive regulations that have sucked crucial liquidity out of the markets and slowed down the banks' ability to respond to volatility and changing risk profiles. While Dodd-Frank was probably right

to end proprietary trading by banks, the sudden loss of trading liquidity across all markets will translate into more volatility and systemic risk in the next big downturn.

The next crash could ricochet out of the currency markets where central bankers have little control. If a central bank raises interest rates to protect its currency, those higher rates hurt domestic economic growth. Since 2009, central banks are increasingly being stranded with terrible options. They include surrendering to a domestic recession to defend the currency, or allowing the currency to devalue and watching the domestic economy collapse as import costs soar and capital flees a devaluing currency.

Regulatory frameworks have become such powerful institutions that answer only to themselves. Compliance managers are under immense pressure to transform themselves from back office processors to a new kind of risk manager in order to understand their expanding responsibilities. Compliance managers may not make the best risk managers, but it appears they will have to be the bank leaders in the next crisis.

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**Tan Boon Gin**  
Chief Regulatory Officer  
Singapore Exchange

## COMMENT

*“I don't believe in focusing in any one particular area. I find you end up fighting yesterday's battle in that area and losing tomorrow's war in another. There needs to be continued activity along the entire front line to be prepared for any new threat or opportunity that will arise.”*

## Room for Flexibility on Valuations



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Given the seriousness of risks around misstating asset values, it is surprising to see that respondents don't expect the issue to be a priority for regulators in 2016. This may be encouraging in that it reflects the significant work already done since the financial crisis. AIFMD in Europe, Dodd-Frank in the US, the implementation of accounting standards such as IFRS13 and ASC Topic 820 have all forced managers to focus on, review and in many cases enhance their valuation processes.

Firms should be wary of complacency, however. For a start, regulation of valuations has already moved from legislation to implementation, and now is increasingly becoming routine. That means inspections. The UK's FCA and its equivalents across Europe have done little in this respect to date, and firms should prepare to see this increase. In the US, meanwhile, regulatory attention is increasingly focused, looking at issues such as fees and expenses that have a valuation reference. Firms must ensure their processes in these areas can withstand regulatory scrutiny.

Despite significant harmonization of international standards, there also remain differences in regulatory approaches between nations for firms to be aware of. The significance of these may well come to the fore in 2016, as regulators focus on tackling difficult issues such as dealing with suspended trading.

More fundamentally, some of the volatility seen in 2015 has also highlighted a significant conflict. On the one hand, regulators continue to insist on clarity, precision and certainty for investors in valuation policies. On the other, volatility in the micro or macro-economic environment can have a profound effect on valuations.

The challenge ahead for firms will be to ensure valuation policies and processes are specific, rigorous and robust enough to satisfy the regulators, as well as dynamic and flexible enough to cope with rapidly changing market conditions all while meeting investors need of for transparent, consistent, decision useful information.





## Blockchain: This Is a New Day, a New Beginning



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Blockchain. Bitcoin. Cryptography. Nodes. Distributed ledger. These are just some of the terms that are rapidly moving from the world of computer experts to multinational financial institutions and regulators.

Research indicates there are now 192 start-ups engaged with blockchain for financial services<sup>14</sup> and investment in blockchain related enterprises is expected to surpass \$1bn in 2015 alone. To understand this direction of travel, we must first remember the primary basis of our current financial system - trust. In a world of digital records, we trust banks, insurance companies, asset managers and other firms with our money, identity and assets. We trust them to maintain books and records to record our holdings securely without the risk of tampering.

In turn, markets rely on centralized ledgers held by custodians and/or central counterparties as the 'golden source' for reconciliations and asset/money ownership. The trillions of transactions that occur daily on a global basis rely on checks and balances within the financial system that fundamentally boil down to a level of trust that centralised ledgers will not catastrophically fail.

In comes blockchain. An astonishingly simple concept that creates either an open (permissionless) or closed (permissioned) distributed ledger that is neither owned nor controlled by a single party, yet requires approval before any transaction is 'added' to the blockchain. Transactions are verified within a blockchain through complex cryptography requiring significant computing power, making it effectively impossible to tamper with. Once transactions are approved, they are added as part of the next block in the chain and distributed for everyone to see.

Simply put, a distributed ledger using a blockchain would enable two counterparties, who have no particular confidence in each other, to interact and transact without going through a neutral middleman.

The possibilities of blockchain in financial services are endless - from Know Your Customer and other anti-money laundering information to securities clearing and settlement. Imagine a world of instantaneous settlement, unforgeable identity and a revolution in the back-office and middle-office of banks and other financial services firms. It is the ultimate utopia of creating trust directly between unknown counterparties. In fact, a recent report by Santander indicates that the technology could save banks alone \$20bn per annum by 2022. Daniel Alter from itBit also raises in this report how blockchain will help both the industry and regulators through more efficient record keeping.

We are many years away from seeing a wholesale revolution in financial services or from knowing which companies will endure. Regulation will undoubtedly follow innovation as the years progress. However, in a blockchain system without a central authority, mass adoption by users and approval by regulators will not occur until the fundamental questions of security, trust and overarching governance are answered.

The coming years will be interesting to see how regulators keep pace with innovation, and how banks and other investors work in competition and collaboration to realise the potential of blockchain.

<sup>14</sup> StartupManagement, October 2015



**Author**

**Richard Sayers**

Managing Director

Enhance Group (Singapore) Pte Ltd

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# Singapore's Thriving Trust Industry Attracts International Expertise

The Singapore trust industry continues to attract top talent from within and abroad, with a significant influx of international expertise stemming from the Channel Islands.

With 53 holders of Trust Business Licenses<sup>15</sup> in Singapore in December, former Channel Islands professionals have been appointed at Managing Director or Board level in a number of organizations. These include the likes of Asiatic Trust Singapore Pte Ltd, Citco Singapore Pte Ltd, Credit Suisse Trust Limited Singapore, Deutsche Bank AG, EFG Trust Company (Singapore) Ltd, First Names Singapore Pte Ltd, Singapore Trust Company/Bedell Trust, Vistra Singapore, and my firm that provides services to the trust sector, Enhance Group (Singapore) Pte Ltd.

This could be down to a number of factors. One is simply the continuing changes in the ownership of trust businesses, and the resulting staff changes. Banks continue to refocus on core activities, for example, with the likes of Barclays and Royal Bank of Canada selling parts or all of their international trust businesses across various jurisdictions.

At the same time, the trust sector, like many services, is becoming increasingly international. Private equity backed and independent trust companies continue to expand, with many that originated in the Channel Islands and Isle of Man looking to establish or expand in Asia, particularly in both Singapore and/or Hong Kong. To remain competitive and service clients with interests across the globe, trust companies increasingly need to offer expertise across jurisdictions.

There is also, of course, the rapid growth in the Singapore trust industry itself, driven by the country's position as one of the world's leading financial centers and growth in the Asia Pacific region. Asia Pacific now has the highest (4.7 million) and fastest growing number of high net worth individuals in the world, according to The World Wealth Report.<sup>16</sup> The number of trust licenses has more than tripled since the major law reform of 2004, and I believe there are a number

of organizations in the process of applying for licences so the number may continue its upward trajectory in 2016. Such rapid expansion has helped fuel demand for trust professionals, not all of which, in growing sector can be met locally.

### A regulatory response

Yet all this does not quite explain the particular prevalence of Channel Islanders in the Singapore trust industry. Why not appoint from Hong Kong instead for example – a market with a large pool of talent and where the trust law since the 2013 reform is broadly similar to that in Singapore?

I'd suggest one answer lies in the key difference that remains between the Hong Kong and Singapore trust industries. In Singapore, companies providing trust services are licensed under the Trust Companies Act and are supervised by the Monetary Authority of Singapore (MAS). Hong Kong by contrast does not regulate trust companies. It is the experience of operating in highly regulated environments that makes Jersey and Guernsey practitioners attractive to Singapore's trust companies, outweighing any regional differences there may be between the markets.

This makes sense particularly when you consider the approach many companies are taking as they seek to establish and bolster their international presence. Managing regulatory risk across multiple jurisdictions is complicated by the different requirements even in regulated markets. Increasingly, therefore, groups are working towards global policies and procedures that meet the requirements of the highest regulatory regime in which they operate, regardless of whether they are needed in each particular jurisdiction, and adopting best practice across businesses.

In an environment where there is the requirement for high-quality financial advice from experienced and qualified practitioners, international opportunities and demand will continue to grow for talented trust professionals – whether they are from Singapore, the Channel Islands, or other jurisdictions.

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**Marco Zwick**  
President  
ALRiM: Luxembourg  
Association for Risk  
Management

## COMMENT

*“Over the past years regulators and policy makers have focused on minimum capital requirements and bank recovery and resolution plans. Future focus should be on a consolidation of international regulatory initiatives to ensure a consistent framework which governs and supports the financial industry globally.”*

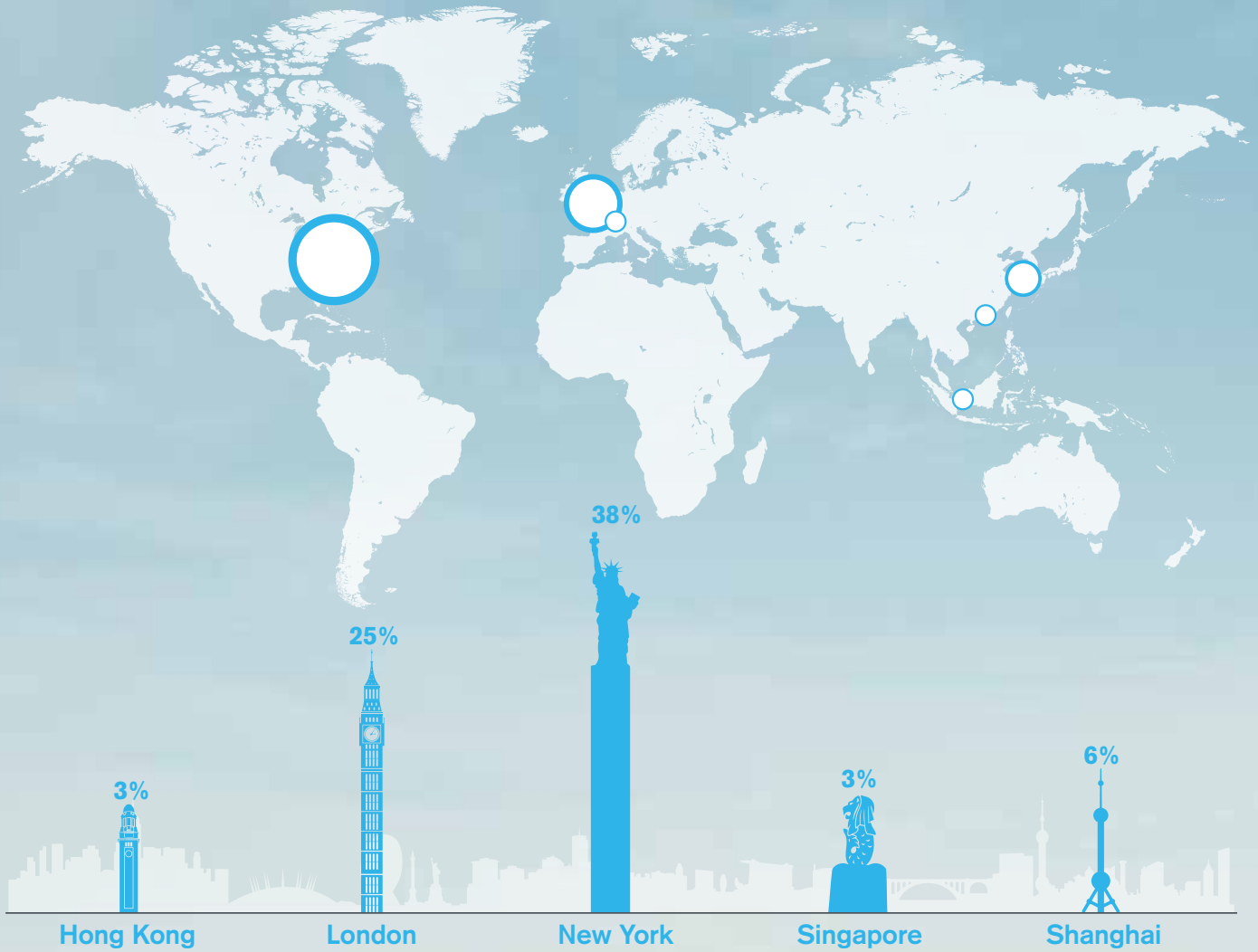
<sup>15</sup> MAS Financial Directory December 2015

<sup>16</sup> <https://www.uk.capgemini.com/thought-leadership/world-wealth-report-2015-from-capgemini-and-rbc-wealth-management>

**Figure 5 - WHICH DO YOU BELIEVE IS THE PREEMINENT GLOBAL FINANCIAL CENTER IN FIVE YEARS TIME?\***

\* Note: the figures do not include respondents who selected "Don't know"

**■ IN FIVE YEARS TIME?**



## A New Financial Center Emerges



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The attraction of the US market for overseas financial institutions is underpinned by New York's continuing status as the world's preeminent financial center. Only London comes close in our survey – and not that close, with 35% of respondents voting in favor for the city versus 50% for New York.

However, institutions in the emerging markets have increasingly interesting domestic markets to consider as well. For example, our Global Regulatory Outlook 2016 shows Shanghai's growing importance as the leading financial center – with 6% even expecting it to become preeminent overall in five years. As

for emerging financial center more widely, Dubai (23%) and Mumbai (14%) are the key ones to look out for.

Of these two emerging centers, Mumbai is a new entrant to our survey and possibly the more notable. Not only is it benefitting from continued growth as China and other BRICs falter, but it also serves as a gateway to other Southeast Asian countries such as Thailand, Singapore and Vietnam. Just as with China, as interest in it grows, institutions based there are increasingly looking to the regulatory requirements they must meet to make themselves attractive to domestic and overseas investors alike.



## The Numbers Stack Up for Ireland



**Author**

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For more than 25 years, Ireland has been a leading domicile for internationally distributed investment funds of all shapes and sizes as well as the home of the Irish Stock Exchange, the leading center for the listing of investment funds. Currently over 800 global fund managers have assets administered in the country and 21 of the top 25 global asset managers have Irish domiciled funds.<sup>17</sup>

From traditional “long only” to complex alternative strategies, Ireland offers world-class, innovative product solutions catering to the widest spectrum of investment strategies. Through our regulatory advisory and management company work with many in this industry, clients tell us they choose Ireland due to its: transparent investment environment; robust yet pragmatically regulated structures; strong emphasis on investor protection; efficient tax structure; and proactive service culture.

Ireland is the fastest growing UCITS domicile with asset inflows growing over 10% each year for the last three years. Irish UCITS are distributed in over 70 countries worldwide, with an equivalent number of favorable tax treaties in place. The domestic tax environment is also beneficial with no tax on income and gains at fund level, and non-Irish investors not subject to Irish tax on their investment. Given the international nature of fund distribution under UCITS, our clients also take comfort that 30 languages and 28 currencies are supported.

For alternative managers, it is no less impressive. The first regulated alternative investment fund was established in Ireland and over 40% of global hedge fund assets are serviced out of

Ireland. With the introduction of AIFMD, Ireland has seen an uptake in alternative funds being created. Equally, Ireland is now a leading domicile for AIFMs looking to sell AIFs into Europe. We are also seeing a trend of alternative managers, uncertain exactly how AIFMD will play out, establishing liquid alternatives in the form of UCITS.

Ireland has some interesting developments going into 2016, particularly with the enactment of the Irish Collective Asset Management Vehicle (ICAV) legislation. The ICAV is a new corporate structure designed specifically for investment funds, both UCITS and AIFs. As a tailor-made fund vehicle, the ICAV effectively ring-fences itself from some of the more onerous aspects of European and Irish company law while offering certain tax advantages for US investors particularly.

The primary advantage though in an international sense is that the ICAV will be able to elect in its classification under the US “check the box” taxation rules to be treated as a transparent entity for US federal income tax purposes. This will allow US taxable investors to avoid adverse tax consequences that would normally apply to “passive foreign investment companies”.

All in all, the Irish funds industry is in good health. And while the numbers stack up nicely, perhaps the strongest argument for doing business in Ireland though remains the skills, expertise and experience of those in the industry which our clients regularly point to as the deciding factor in coming to, and staying in, Ireland.

<sup>17</sup> Irish Funds: <http://www.irishfunds.ie/facts-figures>

## Luxembourg: An AIFM Center of Substance in the Making



### Author

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Luxembourg's investment sector is strong. The Grand Duchy is home to around 4,000 funds and 14,000 fund units, and the market is growing fast.

According to the Association of the Luxembourg Fund Industry (ALFI), UCITS and AIFs based in the country have grown by 23% over the past year, and now total some €3.58 trillion. Over 75% of the world's UCITS funds are located here.

This success is testament to the work of Luxembourg's financial authorities in making the country the go-to destination for establishing regulated funds. And the EU's Alternative Investment Fund Managers Directive (AIFMD) presents an opportunity for the jurisdiction to make the next transition. Under the new regulation, Luxembourg has the potential to move from being an established domicile for funds, to also become a fund management center of substance.

### Work to do

Thanks to its UCITS heritage, Luxembourg has a competitive advantage in this respect. With 42,000 professionals, 190 management companies and 149 banks, it already has the necessary operating infrastructure.

But there's still work to do. The country must ensure it has sufficient skills, knowledge and experience to fulfill AIFMD's demanding 'substance' requirements.

To achieve this, the authorities can't simply recycle what fueled Luxembourg's UCITS boom. The UCITS and AIFMD frameworks are distinctly different. While the UCITS IV rules govern the funds themselves, AIFMD regulates the people that manage them.

As such, AIFMs will not base themselves in Luxembourg simply due to its reputation as a UCITS center. To become the default

choice for AIFM registration, Luxembourg must demonstrate that it can provide the substance required to help fund managers comply with the AIFMD regime.

This will require innovation and culture change. To support a wider range of risk requirements under AIFMD, firms in Luxembourg will need the right skills across all dimensions of alternative fund management, including operations, technical expertise, systems, processes, and staff.

### Think global, comply local

Of course, investment managers are free to choose where they domicile an alternative fund. To market and manage an AIF across the EU, it doesn't matter where the fund is located, as long as the fund manager can meet requirements demanded by AIFMD.

Luxembourg is strongly placed to develop the substance that will help investors to achieve this. Asset managers anywhere in the world can rely on third parties such as ourselves in the Grand Duchy to act as their AIFM, instead of having to establish their own local operation.

What's more, locating funds and their AIFMs in Luxembourg will drive synergies and efficiencies, given the proximity of operations, service providers and regulators.

### A bright future

The prevalence of alternative funds in Luxembourg can only help the jurisdiction build the capabilities AIFMD demands, such as regulatory oversight and risk management.

Along with Ireland, therefore, Luxembourg is poised to become one of Europe's two main AIFM centers of substance.

**Author****Nicola Palios**

Owner of MP Corporate Solutions Limited, Co-owner and Vice Chairman of Tranmere Rovers Football Club Limited, and a Non-Executive Director

## A View From the Inside: Diversity on Boards

Over the last 25 years I have sat on boards in a diverse range of industries - as CEO of a law firm, NED of a PLC and executive vice chairman of a professional football club. All are viewed as male dominated at the boardroom level. So what has it been like in practice?

In law, although I witnessed two or three incidents of blatant sexism, I was fortunate to work in a firm where gender was never a consideration in partnership discussions. Around 30% of the firm's partners were women and no one batted an eyelid at a woman being elected CEO. But my experience was not typical.

Although 62% of UK qualifying lawyers are women, only 24% of partners are female,<sup>18</sup> and only 8 women hold senior management positions in top 50 UK law firms.<sup>19</sup> The stock rationalization is that law is a difficult career to combine with motherhood, but that is a lazy and simplistic explanation. Some women do drop out of the profession to have children, but the majority don't, and I suspect sub conscious bias is a bigger factor in the poor progression. Human nature is such that we have a tendency to surround ourselves with

people in our own image, so white male-dominated firms are likely self-perpetuating.

This may explain why within that 24% female partner statistic, there is huge variation. In the top 100 firms, the most gender-diverse firm has more than 50% female partners, while the worst has a paltry 5%.<sup>20</sup> We should be challenging the firms at the bottom of this list to analyze why they are as they are. I am sure they would be horrified to be labeled sexist, but it is hard to avoid the conclusion that there is something wrong with their selection procedures if they can find nineteen males of partnership quality for every one female.

In "Plc land", there has been enormous pressure to diversify boards and although progress has been slow, it is undeniable. Around 23% of FTSE directors are now female, but largely because



of NEDs. Only 8% of blue chip executives are women. The statistics are surprisingly similar to law, and I expect that many of the root causes (particularly unconscious-bias) are the same too.

I am not wedded to the idea that gender-diverse boards will always be better. The research is fairly inconclusive – and I am against quotas. But diversity inevitably brings different perspectives - a bit of grit in the oyster that can form the pearl - and reduces the propensity for “group-think”. Board composition should surely represent the markets a company serves and the stakeholders it engages with, so that their perspectives can be understood. There are very few businesses nowadays where the only customers are white males.

Which brings me to football. Although undoubtedly significantly more men play and watch football, women’s numbers are substantial and rising fast. Furthermore, the football’s governing bodies are out of step with what the average male football fan wants: a 2015 survey found that 90% of male respondents wanted to see more female sports journalists, 86% wanted more women on football boards and 30% now follow their Clubs’ women’s team.<sup>21</sup>

At club level, there is huge variation. Tranmere is an old club in a solidly working class area. You might therefore expect it to be male chauvinist, but it had one of the first female Chairwomen and has developed many female international players. I have never experienced any sexism from the Club’s supporters, but I have seen it at other Clubs, including one which maintains a ban on women in the boardroom.

So my conclusion is that there is no such thing as a profession which is sexist, but individual companies certainly can be. Looking at industry statistics can be very misleading when there is such huge variation in equality within each industry. Women would be well advised to choose carefully the company they work for if they want to realize their professional ambitions. In the meantime, those of us who can afford to rock the boat need to shine a spotlight on those businesses which continue to marginalize women.

<sup>18</sup> 2014 Gender in the Law Survey, Chambers Student

<sup>19</sup> The Lawyer, <http://jobs.thelawyer.com/article/where-are-the-women-law-firm-leaders/>

<sup>20</sup> 2014 Gender in the Law Survey, Chambers Student

<sup>21</sup> University of Leicester and Loughborough University research



# RESPONDING TO REGULATORY AND INDUSTRY DEVELOPMENTS

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**Author**

**Harald Collet**

Global Head

Bloomberg Vault

# Taking a Platform Approach: Six Steps to Recordkeeping Compliance Under MiFID II and MiFIR

Together with MiFIR, MiFID II will introduce broader transparency measures, and operational and compliance requirements aimed at shoring up investor and consumer protection.

MiFID II and MiFIR will change the way firms around the world do business with European counterparts, particularly with respect to the scope of data, communications formats and records that must be maintained.

While the implications of the regulations on financial institutions are very broad, they pose unique new requirements in the areas of recordkeeping, trade reconstruction and market abuse prevention that will require firms to manage more data types and handle a materially higher volume. Firms should consider a “platform approach” to these requirements as the most reliable, efficient and cost-effective means for demonstrating MiFID II compliance readiness.<sup>22</sup> This type of approach enables firms to compete effectively in a climate of rigorous client due diligence, while providing evidence of the culture of compliance that regulators demand.

**Key steps:**

1. Establish a taskforce and recordkeeping workstream: draw members of the taskforce from legal, compliance, technology and the business to teach them the distinctions between MiFID and MiFID II that pertain to the firm.
2. Execute an internal assessment: assess the firm’s current capabilities in the areas of data capture and management, digital communications, voice, and trade archiving to identify any gaps in the processes and technologies in place.
3. Document business and technology requirements: recordkeeping workstream teams should identify system-level impacts and operational refinements that must be made in order to align with MiFID II requirements. They must also develop a recommended

implementation schedule and create detailed business requirements for each system and process affected by the new rules.

4. Develop policies, procedures and testing: construct new processes, procedures and policies for MiFID II/MiFIR recordkeeping compliance and surveillance in such areas as order handling, execution, order placement and transmission, complaints handling, conflicts of interest and remuneration.
5. Educate internal stakeholders: provide an overview for internal stakeholders of the impact of MiFID II/MiFIR trade requirements on the business, operations and systems for recordkeeping and market abuse prevention.
6. Execute testing and ongoing improvement: periodically test the new MiFID II/MiFIR policies, processes and procedures to confirm their recordkeeping compliance with the new regulations and the quality of the outputs. In addition, conduct forensic tests to isolate outliers among the data.

### **Taking a holistic approach**

Expanded recordkeeping, trade reconstruction and market abuse detection requirements under MiFID II may be daunting. However, firms that approach the challenge holistically and methodically—assessing their readiness, identifying critical gaps and creating a plan of action to close those gaps—can significantly streamline their preparation effort.

And streamlining is critical – given that there is a significant amount of overlap across MiFID II, MAR and DFA. For global firms with operations in the US and Europe, there is substantial benefit to taking a holistic approach to addressing these regulations, which mandate the retention of records and communications for all services, activities and transactions to enable national regulators to monitor compliance.

By implementing a platform approach to address technology gaps, firms can achieve the high-water mark for MiFID II recordkeeping, trade reconstruction and market abuse detection and install a fully defensible compliance program.

### **Long-term payoffs**

MiFID II is most likely only the first in a series of regulations. Beyond it lie a multitude of buy-side and sell-side directives and regulations that are at various stages. Firms that are able to leverage their MiFID II-compliant platforms, systems and processes, and the attendant recordkeeping capabilities for future directives and regulations, will be strategically positioned to deliver new and important insights to the front office, allowing senior management to assess and identify risk, support strategic decisions, and provide value to the firm's stakeholders.

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**Pat Lardner**  
Chief Executive  
Irish Funds

## COMMENT

*“As policy makers strive for growth and investment they are encouraging industry to do its part and this dialogue is welcome. Separately, regulators are at varying stages of reform implementation. The key focus should be providing clarity and certainty so growth enhancing initiatives can proceed within a stable regulatory environment.”*

## AIFMD and the Evolution of Risk Management



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Risk management in the alternative investment industry is changing. Recent legislation – in particular, the EU’s AIFMD – has transformed the role and purpose of the function.

Risk management has traditionally concerned itself purely with portfolio decisions. But under AIFMD, it has become a more holistic role, embracing all dimensions of the investment value chain: portfolio, operational and liquidity risks, as well as risks delegated to third parties.

### A new reality

As a result, risk managers have become increasingly reliant on systems, processes, and procedures, and on more personnel, to remain compliant. At the same time, they are having to take on a far more detailed understanding of the risks affecting the third parties their firms work with. This includes brokers, custodians, administrators, and any other organizations that support their operations.

What’s more, AIFMD has changed the very purpose of risk management in alternative funds. In the past, trading positions were taken, then evaluated for their potential risks. But under the new rules, risk management must be embedded in the decision-making processes that happen before investments are made.

Some larger funds have long had these sorts of arrangements in place. But under AIFMD, all alternative fund managers must systematically take a ‘pre-trade’ approach to risk management. As a result, we’re seeing much greater collaboration between the risk and portfolio management functions within hedge funds, on critical tasks such as risk attribution and margin-at-risk impact.

### Model limitations

A good example of pre-trade risk management in action is among systematic commodity trading advisers (CTAs). CTAs use sophisticated algorithms to detect market signals and make their

investments. As such, there’s little involvement from risk teams in the ‘live’ decision-making process.

Risk managers are deeply involved in the validation of the risk models on which trading algorithms are based, which means greater caution being applied when testing the resilience of trading models.

Of course, caution is not a bad thing when it comes to risk management. But no amount of caution can help risk models to predict future volatility.

It’s therefore essential to be aware of the limitations of risk models. As well as considering what the models say, it’s important to be attuned to the qualitative risks at hand. Rather than being seen as decision-making tools, models like the Black-Scholes formula for pricing commodity options should be used merely as starting points.

### Paradigm shift

The truth is that AIFMD represents a new paradigm for risk management in alternative investment funds. Adapting to the new rules will demand a change of philosophy, culture and mindset among risk managers.

We’re already seeing this evolution begin to happen among the industry. Risk managers are increasingly conscious of the limitations of risk models, and are less inclined to see them as an accurate picture of reality. As a result, they’re applying more rigorous governance to the models they use.

With a greater focus on risk, and heightened awareness of the limitations of risk models, the alternative investment industry is working harder than ever to ensure they operate safely in today’s financial markets.

## Valuations: A Matter of Opinion



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Valuation professionals were confronted with an onslaught of new challenges in 2015. Most noteworthy were the suspensions of equities following the devaluation of the Chinese Yuan in July and August and the Greek capital controls that were implemented in June. In addition, declining oil prices and a growing number of private start-ups with valuations of over \$1bn – so called “unicorns” (of which there are 144 at the time of writing) – added to the list of challenges for investors trying to assess the value of their portfolios.

The implications of these developments vary widely, but in one respect they are consistent. They all significantly increase the level of subjectivity into the valuation process – either introducing subjectivity where none previously existed (as in the case of the equity market suspensions) or, in the case of the latter two examples, significantly increasing the level of subjectivity involved.

This is clearest with the market crises in China and Greece. Hedge funds and others with exposure to the publicly listed equities in these countries were used to being able to access pricing on a daily basis. In the absence of daily observable trading, however, the approach to valuing their stocks inevitably involves significant subjectivity. Simply using the last traded price for such holdings would, first, probably be inappropriate given the reasons behind these suspensions, and, in any case, represent a subjective decision in itself.

In the cases of unicorns the issue is less obvious. There will obviously be both winners and losers. For those that have recently completed funding rounds, firms may have a good anchor point for their valuations. However, where companies are struggling or have not been able to raise financing recently, valuations are considerably less certain.

So, too, with the impact of declining oil prices, where the issue is more widespread. Market participants across the energy sector will have been affected and, indeed, so will the economy as a whole. Valuations of private companies heavily exposed to oil prices, however, must be a particular concern. Objectivity in valuations in such case is largely illusory.

The element of judgment in all these cases means there is no right answer to how they should be treated in terms of valuations. Much will depend on the particular circumstances of a fund – whether it is open-ended or closed, its reporting period, and current valuations policy, for example.

However, both investors and regulators will expect to see that funds have revisited their valuation policies in light of these challenges. Moreover, in terms of governance, firms should be able to show they have the capabilities and experience in their teams to make such judgements and to oversee them. With AIFMD and, particularly, the FCA's focus on the subject, firms must also ensure they can show the scope for such judgments does not compromise the valuation's independence.

When it comes to such subjective matters, no two valuation professionals will come to the exact same conclusion on the impact of all these developments, of course. However, the need for a robust, auditable, well-documented and independent framework within which to consider them is increasingly not up for debate.

## Global Clampdown on Tax Evasion



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Following in the footsteps of FATCA, the OECD's Common Reporting Standard (CRS) came into force at the start of 2016. Financial institutions in early adopter countries such as the UK and other EU Member States, the Cayman Islands, Jersey and Guernsey, needed to establish the tax residency of existing customers as at the end of 2015, and from January 1 this year must also do so for new accounts. Due diligence is to be completed for pre-existing high-value individual accounts by December 31, 2016 and all other accounts by December 31, 2017.

The CRS has been dubbed "global FATCA" or "GATCA" by some. On one hand, coming as it does in the wake of FATCA, the CRS may appear less revolutionary. The similarities mean that any organization that has already put in place procedures and systems to cope with FATCA should be well placed to begin to meet the requirements under the new global regime. Moreover, the first reporting under the CRS is not until May 2017, so there is still time to prepare.

On the other hand, there is no time to lose as the CRS is now in force for many countries and there are some important differences between FATCA and the CRS that are worth noting to avoid being tripped up. Reporting limits, for instance, are different. While firms under FATCA do not need to report individual accounts under US\$50,000, there is no minimum under the CRS. Exemptions under FATCA are also more numerous than the CRS which does not expressly carve out investment managers and advisors, and also omits the "regularly traded" exemption from which many listed funds benefit under FATCA.

The biggest difference between the two, however, is simply one of scale. Under FATCA, the focus is on US account holders, although firms in the UK, its Crown Dependencies and Overseas Territories are also concerned with UK and Crown Dependency account holders under "UK FATCA". Both regimes though, are focused on clients in only a few countries. By contrast, by November 2015, the number of signatory countries to the CRS stood at 96.<sup>23</sup> This makes it an entirely different challenge.

First, while many organizations – particularly smaller ones – and their clients may not have been significantly affected by FATCA, that is less likely to be true with the CRS. A reasonably straightforward binary determination of an absence of US taxpayer clients which many offshore funds undertook for FATCA is no longer sufficient. Even with due diligence and reporting deadlines stretching into 2017, CRS is here now and firms are well advised not to wait.

<sup>23</sup> <https://www.oecd.org/ctp/exchange-of-tax-information/automatic-Exchange-Financial-Account-Information.pdf>



**Author****David Dalton-Brown**Director General  
TISA

# Pension Tax Relief and the Financial Advice Market Review

2016 will be another year of significant change before the impact of the UK Treasury's consultation on pension tax relief and the Financial Advice Market Review (FAMR) is known.

The consultation on pension tax relief could fundamentally change pension savings in the UK, impacting all aspects of the distribution, product development, servicing, operations and customer services of both individual and workplace pensions. This level of change could disrupt current pension markets, with existing pension providers having to change large aspects of their business models.

FAMR could change the regulation that governs the delivery of financial advice and introduce new regulation to support financial guidance together with the products to support this guidance. As with the pension tax relief proposals, the impact of FAMR on distribution, product development, servicing, operations and customer services could be significant. Furthermore, we may for the first time see the development of regulation to support the delivery of automated/digital advice and guidance.

This level of change will be layered on the changes required by the industry to support MIFID, Solvency II, FACTA and Client Assets for example.

However, one area of regulation that is not being addressed through current regulation and is becoming an issue for consumers following the introduction of pension freedoms is the rise of unregulated investment schemes and products (such as airport parking investments, self-storage schemes, etc., that have advertised guaranteed returns of 8% plus). These schemes will cause consumers major problems if not properly controlled. It is time we look to drive these schemes out of business along the same lines CORGI have helped prevent unregulated plumbers from trading.

2016 is going to be a year where regulatory change will create both major challenges and opportunities. Financial service businesses will have to make highly considered choices on the application of skilled resources across the firm to take advantage of both the business opportunities created by new regulation and to meet mandatory regulatory change.

**Geoff Cook**  
Chief Executive Officer  
Jersey Finance

## COMMENT

*"The appropriate and proportionate level of regulation should continue to be a focus for regulators and policy makers with particular attention paid to international consistency. For multinational businesses, clear and consistent rules across jurisdictions have the power to minimise errors, reduce costs and enhance customer experience while rebuilding confidence in the industry. Jersey continues to adhere to the highest standards in transparency and regulation but it is time for a level playing field to be established."*

## The Choice Between In-house and External Valuation Is Not Binary



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The use of external valuation advisors is an obvious way to enhance a firm's valuation process and internal controls by adding a visible layer of independence. Regulators have encouraged it, and its use is likely to grow in the coming year, as the Global Regulatory Outlook 2016 findings shows: it was, by a narrow margin, the most common method for firms looking to improve their process.

Some will be put off by the additional expense, which will ultimately be borne by investors. However, good governance ultimately benefits investors and it is not unreasonable for them to at least partly bear the costs.

Firms should, however, be careful how external valuation is used. Most importantly, they should be absolutely clear that valuation is not a duty firms are able to outsource.

AIFMD has perhaps contributed to confusion in this space, stipulating only that valuation should be "functionally independent from portfolio management". This has led some to suggest valuers should not even seek the portfolio manager's input, while holding the external valuer alone responsible for valuation.

Both are incorrect assumptions. First, no one is likely to have as much knowledge of the investments as the portfolio managers, making their input vital. Second, while the firm can take advice from a third party, they are not bound by it, and firms remain ultimately responsible for valuation estimates. It is an immutable part of their fiduciary duty. The UK's FCA made this clear in a consultation document earlier this year,<sup>24</sup> but it is equally true in other jurisdictions.

For firms, then, it is not a choice between external valuation advisors or in-house expertise. Rather it is the two working together that will achieve the best results, drawing on the knowledge of those who know the investments best, while providing that additional reassurance of independence to give investors and regulators peace of mind.

<sup>24</sup> <https://www.fca.org.uk/news/cp15-08-qcp-8>

## Expense Allocation: The New Focus for Private Funds



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The US regulatory landscape over the past ten years has focused on private funds. It is clear from recent actions that regulators are focused on fee and expense allocation procedures. It will continue to be a main focus, especially with the creation in April 2014 by the SEC's Office of Compliance and Examinations of the Private Funds Unit with its sole commitment of examining advisers.

What is unique about this current issue is that there really are no rules which specifically address it, nor have the regulators issued any formal guidance concerning expenses. Duff & Phelps believes that based on recent settlements, the SEC is focusing on the following areas: allocation of expenses; transparency; conflicts of interest; charges for additional services; co-investment vehicles; allocation of vendor discounts; and related party fees.

As the SEC continues its examinations of private funds, we are encouraging investment advisers to ensure their compliance policies are strong and that they bring in independent advisers on fee and expense allocation issues. Through the implementation of specific controls, an investment adviser can ensure that disclosures in fund offering documents and partnership agreements are clear, accurate and complete when it comes to fee and expense practices. We believe that identifying any potential conflicts of interest in expense allocations is a key

control that the SEC will be on the lookout for. There must be a specific evaluation process for internal allocation and policies for the charging of expenses for the certain activities of various entities and portfolio companies.

The assessment and allocation of fees and expenses has proven to be in the beginning stages of the 'next big thing,' and as such, should (and will) gain the attention of the investment community. Making your firm focus on expense allocation and following the aforementioned suggestions can help alleviate the ramifications should the regulator come knocking on the door.

## Investigations in a Big Data World



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Beyond emails and social media evidence, financial, accounting and other business documents often comprise important evidence in internal corporate and regulatory investigations. Data dumps are simply the starting point. Thoughtful consideration should be given to data extractions from systems, as well as the collection of other forms of electronic records used in investigations. Case strategy and tactics are used to produce the most successful outcomes which increase investigators' abilities to collect data and information most useful to the inquiry.

For all types of electronic evidence, it is important to consider the availability, age and volume of data. It is often necessary to collect both active and archived data. Additionally, it is important to understand the definitions of data fields and their structure to determine such factors if fields are overwritten in the normal course of business, as well as the controls and authorities for populating, changing and approving data and controls.

During investigations and before downloading data for testing, we typically prefer to interview personnel with knowledge of data and systems. This, however, is not always possible. An alternative is to perform preliminary tests before all the data is pulled so that we can evaluate the completeness and usefulness of the information that is available. Almost certainly, not all information is available; but we can plan accordingly through statistical and other methods to ensure tests are robust.

It can be more challenging in the world of electronic business interactions and records to make requests for original "source" documents. For example, accounts payable and accounts receivable records (such as invoices and purchase orders) may not exist in the traditional sense of the word. An alternative may be to request interviews and a dialogue that leads to an efficient outcome, both on terms of speed and ability to achieve the result.

In using these methods, we can be successful in performing tests of accounting and financial information.





For more information please visit:  
[www.duffandphelps.com](http://www.duffandphelps.com)



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