

A photograph of a sailboat's mast and rigging against a sunset sky over water. The mast is made of polished wood and is covered with various ropes and pulleys. The sky is filled with soft, orange and yellow clouds, and the water in the background is calm. The overall scene is serene and evokes a sense of adventure and exploration.

DUFF & PHELPS

Protect, Restore and Maximize Value

# Global Regulatory Outlook

**VIEWPOINT 2018** OPINIONS ON GLOBAL FINANCIAL SERVICES REGULATION  
AND INDUSTRY DEVELOPMENTS FOR THE YEAR AHEAD

2018



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**INTRODUCTION**

# Executive summary

The regulatory burden increases inexorably, but promises of regulatory harmonisation never seem to deliver. Perhaps that's a good thing.

The more things change, the more they stay the same. With Brexit and Trump dominating global headlines last year, much of the resulting uncertainty persists in our Global Regulatory Outlook 2018 survey.

Both developments have yet to play out. On Brexit, negotiations continue with financial services regulation and access remaining among the many sticking points. In the United States, we are beginning to get a sense of the priorities of new Securities and Exchange Commission Chairman Jay Clayton, but it remains early days.

It is clear, though, that there will be little let-up for financial services firms. In the EU, firms began the year with implementation of Markets in Financial Instruments Directive (MiFID) II and imminently face introduction of General Data Protection Regulation (GDPR) in May (where almost half in our survey are not confident they are on track to comply). Struggles with the Senior Managers and Certification

Regime (SM&CR) in the United Kingdom also continue. In the United States, meanwhile, it is fair to say that, whatever else, the campaign pledges of the Trump administration to dismantle the Dodd-Frank Act remain mostly unfulfilled.

At any rate, few expect the regulatory burden and impact to ease: 95% say regulations will increase their costs this year, and almost a quarter (24%) in our survey said they would be spending more than 5% of their annual revenue on compliance by 2023. In fact, a tenth (11%) felt they would spend more than 10% on it by that year.

## Cyber certainty

Like last year, the big regulatory growth area remains cybersecurity—only more so. About three in 10 (29%) say this will be regulators' primary focus in 2018, and more than half (54%) think it will be a top-three priority—leaving aside the 22% naming GDPR.



That now puts cybersecurity ahead of even Anti-Money Laundering and Know Your Customer regulations as a perceived regulatory concern. The focus on cybersecurity is only likely to intensify too; as we note frequently in this report, regulatory expectations in this area are still becoming clear.

It's not just regulatory pressure, of course. The spate of cybersecurity breaches over the last year has also contributed to firms' determination to address the issue. For both these reasons, 78% of respondents expect to spend more resources and time on it in 2018.

The key question is whether that spending, and the regulation prompting it, will prove effective.

#### The value of regulation

Past experience is only partly encouraging. On one hand, compared to previous years, confidence in the effectiveness of regulation has grown. A slim majority (51%) now say they expect financial services regulation to increase market stability (up from 42% in 2017).

On the other hand that still leaves 29% saying regulation has no effect on stability and 10% saying it makes it worse. Moreover, the proportion saying financial services regulation is likely to enhance investor

confidence is down to about a third (35%), with 61% saying it has little impact (56%) or damages it (5%).

Certainly, the limits of regulation are well recognised: As in previous years of this report, few believe regulatory changes in recent years have adequately safeguarded against a future crash: only 13% say they have, while 28% say they haven't. The majority (57%) say the risks have been only partly addressed.

#### Be careful what you wish for

Whatever they expect its impact to be, what firms say they want from regulation is greater harmonisation. Almost one in five (19%) say it's the single most important factor in maintaining an effective regulatory system (second only to principles-based regulation).

Most (52%) agree that regulators are improving their ability to coordinate across borders, but few (29%) think they have been effective in establishing consistent global regulatory standards. This is largely the same as in previous years of the Global Regulatory Outlook survey. A more interesting issue, perhaps, is whether firms are right to yearn for those consistent standards.

Of course, it's recognised that regulation can have some positive impacts: A third say it "expands market reach" and almost three-quarters (73%) concede regulations encourage improvements in internal systems and control.

Regulatory harmonisation might alleviate some of the burden and complication of complying with different standards across jurisdictions. Given the tendency when it comes to regulatory alignment to level up to the highest standards in operation and to harmonise without necessarily removing duplication, it's unclear whether greater consistency across jurisdictions would reduce, or add to, the cost of compliance.

### A Brexit bonus?

That's particularly pertinent when it comes to Brexit.

About one in five (21%) in our survey said Brexit had an immediate impact on their compliance programmes with changes already being made or planned for the next 6 months. Another quarter (26%) expect changes within 18 months.

As to how big those changes will be, much will depend on the final agreement reached, but United Kingdom Prime Minister Theresa May has recently ruled out passporting for financial services after the United Kingdom leaves the EU. This, she said, was "intrinsic to the single market of which we would no longer be a member."<sup>1</sup>

The impact of Brexit remains to be seen. Yes, it is a risk—and not one that many of our survey respondents feel terribly confident about. While 53% say London is the current pre-eminent global financial centre, only 29% expect it to be so in 5 years' time.

But it also presents opportunities. Many firms are considering their options in anticipation of Brexit to continue marketing

in the EU, such as using management companies and revising their operating models. But Brexit may also open up opportunities in other jurisdictions through new trade agreements to distribute products. In any case, it remains a complex regulatory and market environment for the industry across the globe, and it will need to be managed dynamically. The success with which firms do so could prove a differentiator in the next few years.

### Grasping the technology challenge

Brexit is not the only opportunity for firms in the regulatory space. To finish where we began, the reason cyber risks are such a key regulatory focus is because of the increasing power and pervasiveness of technology in financial services. Just as firms are embracing this in their businesses, so too are regulators in their work in detecting and preventing market misconduct.

As regulators' sophistication grows, their expectation of firms' own capabilities to automate compliance and market monitoring does, too. On one hand, that's a significant threat for those firms that fail to take up the challenge, particularly in light of the continued drive towards individual accountability evident in the United Kingdom's SM&CR and Hong Kong's equivalent.

On the other hand, though, it could offer two benefits. First, the promise of more orderly markets, which should be good for the industry as a whole and prevent the unscrupulous and unfair gaining of advantage. And second, the potential for solutions that, through automation, actually ease the regulatory burden, and perhaps halt the rise in compliance costs.

<sup>1</sup> <https://www.ftadviser.com/regulation/2018/03/05/may-rules-out-passporting-for-financial-services-after-brexit/>









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# Too much of a good thing?

The costs of regulation continue to increase. According to 19% of our survey respondents, the cost of compliance is approaching 10% of the cost base in their firms.

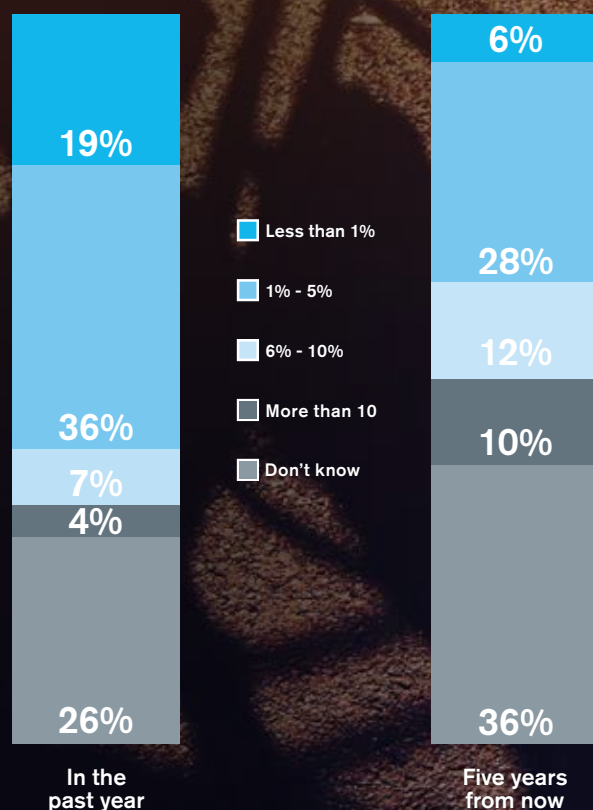
Regulatory developments in the coming year are unlikely to change many minds. With the start of 2018, we have seen not only the long-anticipated introduction of the Markets in Financial Instruments Directive (MiFID) II but also implementation of the International Financial Reporting Standard (IFRS) 9 amongst other changes the coming months and years are bringing many more.

The complaint about much of the regulation implemented since the financial crisis is not just the costs, but also the efficacy. There is no doubt that huge investments and advancements have been made in both compliance arrangements and regulatory oversight in recent years, but many respondents are yet to see the full impact and return in terms of greater protection for investors and a more stable, secure financial system—at least in comparison to the additional work and costs involved.

It is, however, possible to argue that a key aim of financial regulation in the last decade is in fact slowly being realised: cultural change. Individual accountability is providing real incentives on those held responsible to ensure appropriate behaviours (and competence) across their firms. In particular, the Senior Managers and Certification Regime (SMCR) in the United Kingdom is starting to have a profound impact. It is already driving cultural change in the banking industry to which it applies, with plans in place to extend the regime to insurers in December 2018 and all other Financial Conduct Authority (FCA) regulated firms in 2019. While there is yet to be an SMCR enforcement case, a Freedom of Information Request last year to the FCA made by Allen & Overy showed that a small number of SMCR investigations were open. Given the regulator's strong focus on individual accountability as a key part of its regulatory framework and to maintaining market integrity, we may see the first case come to light in the near future. When this occurs, the industry will start to build a better understanding of regulatory expectations and how the rules



AS A PERCENTAGE OF ANNUAL REVENUE, HOW MUCH HAS YOUR COMPANY SPENT OR WILL SPEND ON COMPLIANCE?



impact senior roles; and crucially, continue the cultural shift as intended.

Nevertheless, for some firms, there is evidence that even where there is a genuine desire to comply, the weight of regulation is proving a practical obstacle to doing so. Compliance and Risk are facing unprecedented challenges to stay on top of changes whilst delivering business as usual activity. We see this most clearly in the cases of retaining talented staff leaving roles after short periods or in some cases, the industry as a whole.

Of course, much of the regulation in recent years has been necessary to address past faults. But in continuing to layer on ever-more requirements to firms, governments and regulators are increasingly in danger of seeming to want to test this approach. In any case, this volume cannot continue indefinitely.

Ultimately, it may impact some jurisdictions' competitiveness, as well as the intended spirit and outcomes of the regulation's principals being lost.

With regulators and industry working more closely together and the cultural shift continuing, we may in the future start to see a move away from the continuous implementation of new rules. For example, on making better use of technology to monitor conduct and market behaviour, regulators are using tools currently at their disposals but in more enhanced ways combined with greater regulatory collaboration across borders to streamline regulation, as seen in the airline industry. Innovation and business must still be allowed to flourish; without it, we will all be worse off.





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# Too much too soon?

The regulatory battle against bribery and corruption isn't one French businesses have ever been able to sit out.

Those operating abroad have long been subject to international regulations. Indeed, French groups have been amongst the recipients of some of the biggest penalties under the United States Foreign Corrupt Practices Act.

This might be partly why France implemented its own rules through the Sapin II anti-corruption law. When the law took effect in 2016, France belatedly joined other countries, such as the United Kingdom, that have passed domestic legislation on the issue in the last decade.

The law establishes a criminal settlement procedure and extends the extraterritorial application of French criminal law to international corruption. It also instructed French businesses with 500 or more employees and a turnover greater than €100 million to implement a program by June 2017 to prevent and detect corruption. Penalties for failures under the law are up to €1 million for companies and €200,000 for individuals.

A new body established under the law, the Agence Française Anticorruption, has already begun initial inspections of big businesses to test compliance.

To an extent, the law has simply brought France in line with international standards after years of pressure from the Organisation for Economic Cooperation and Development (OECD) and nongovernmental organisations. Before its introduction, France was ranked 23rd out of 100 in Transparency International's Corruption Perceptions Index, below most other major economies.

The law goes beyond that, though, and for many businesses, compliance is going to prove a significant challenge.

First, the law is not perfectly aligned with either the United States regulation or the United Kingdom Bribery Act. Compliance with one will not necessarily ensure compliance with the other.





For example, the Sapin II requirements for a firm's anti-corruption program are significantly more specific.

More fundamentally, however, the law extends financial crime legislation to a large number of businesses with little to no experience with compliance.

In this respect, financial services firms are well-placed to meet the requirements of the new rules. They are used to dealing with the stringent requirements of financial services regulators and have experience mapping and managing risks—experience that will be vital to ensure full compliance with the new rules. They also have compliance officers already in place.

For once, these firms can perhaps be thankful for the flood of regulation they've faced over the last decade. It will not make compliance with Sapin II simple, but it will help. For others, though, it's likely to be a steep learning curve.





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# Cyber risks beyond your four walls

Even before Mary Jo White, then-chair of the Securities and Exchange Commission (SEC), in 2016 declared cybersecurity risks to be the biggest threat to the financial system,<sup>1</sup> firms were pressured to tackle their cyber exposures. The pressure has only grown since.

At the national level the U.S. has Rule 30 of the SEC's Regulation S-P under which firms must adopt written policies and procedures to protect customer information. The Commodity Futures Trading Commission (CFTC) has also published its rules on IT system safeguards testing.<sup>2</sup> At a state level, meanwhile, as of February, firms must file certificates of compliance with new requirements of the New York Department of Financial Services (NYDFS) to establish and maintain a cybersecurity program.

This last set of rules is among the more detailed and includes requirements that the cybersecurity policy must cover "vendor and third-party service provider management." The NYDFS

is not the first regulator to note that third-party vendors are an area of particular vulnerability, though. The SEC has long recognised this,<sup>3</sup> and, more recently, the Financial Industry Regulatory Authority's examination of firms' cybersecurity also identified weaknesses in some firms' processes for reviewing vendors' security.<sup>4</sup>

With regulatory scrutiny on cybersecurity increasing, it's likely this will become an increasing area of risk for firms—and not just in the United States. In Europe, the General Data Protection Regulation (GDPR) is hugely increasing the stakes this year when it boosts potential penalties for the most serious breaches to €20 million, or 4% of global annual turnover.

<sup>1</sup> <https://www.reuters.com/article/us-finance-summit-sec/sec-says-cyber-security-biggest-risk-to-financial-system-idUSKCN0Y82K4>

<sup>2</sup> <http://www.cftc.gov/PressRoom/PressReleases/pr7442-16>

<sup>3</sup> [www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf](http://www.sec.gov/ocie/announcement/ocie-2015-cybersecurity-examination-initiative.pdf)

<sup>4</sup> <https://www.finra.org/industry/2017-report-exam-findings/cybersecurity>

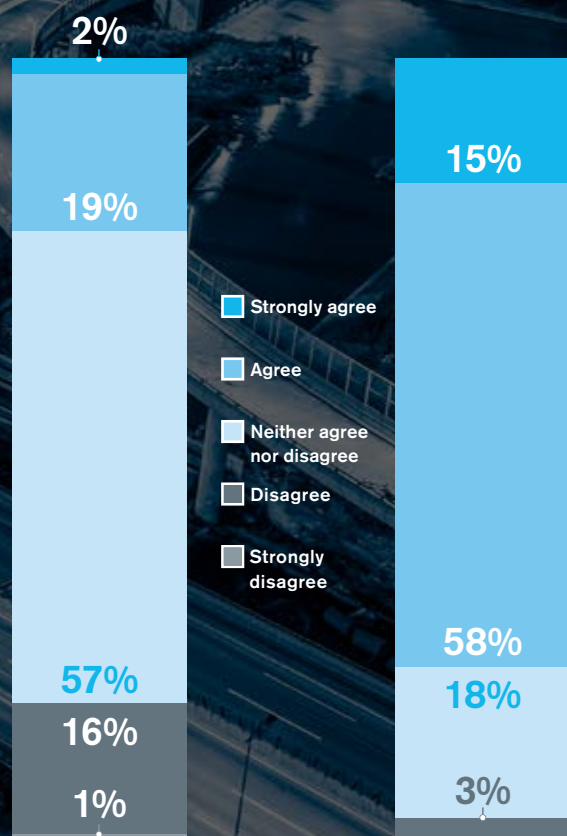


Regardless of the incentives to address third-party cyber risks, getting to grips with them won't be easy for firms. A recent study by the Ponemon Institute found that 57% of companies don't have an inventory of the third parties they are sharing sensitive information with, and the same proportion do not know if third parties' policies would prevent a data breach.<sup>5</sup>

Addressing that will require firms to start by thoroughly mapping their data and tracking its flows throughout the organisation. Funds should be tracked from collection by marketing teams soliciting new funds through document processing and administrator services to redemptions. Staff details should be tracked from CVs and background checks at recruitment to storage of relevant records and removal of logins and access by IT when a staff member leaves.

All these efforts will take time, though, and time is running out. Not only will we almost certainly see regulatory enforcement increasing in this area, but investors' patience is also likely to prove limited. Firms that don't address the risks to clients' data may find that investors take action themselves and decide to put their data and their money elsewhere.

INDICATE THE EXTENT TO WHICH YOU AGREE WITH THE FOLLOWING STATEMENTS:



The SEC's focus for 2018 will be on retail investors and not private funds

Given the global regulatory focus on cybersecurity and the spate of recent cyber breaches, our company plans to focus more resources and time on cybersecurity

<sup>5</sup> <https://www.opus.com/ponemon>





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# The consequences of concentration in private equity

One of the interesting features of a robust private equity (PE) marketplace has been the ever increasing amounts of capital raised for the purpose of investing in privately held firms. Money is increasingly flowing to a select group of big brand name firms who can seemingly raise money at will. The 10 largest private equity funds closed in 2014 accounted for 19% of overall fundraising for that year. By 2016, that had risen to 26%.

It's a trend that looks likely to continue in the coming year. More and more money is flowing to a relatively few big brand names. PE is increasingly looking like other parts of the investment industry, with a bifurcation in the market: a few behemoths dominating with a lot of regional boutiques making up the rest of the market.

That outcome is driven largely by the institutional investor market in private equity, including pension funds and sovereign wealth funds, and their consultants. Advisers recommending the well-known names are less likely to be second guessed by their client's investment committee than those selecting smaller emerging

private equity managers. The concentration of capital is therefore, perhaps, inevitable. But it isn't without consequence.

One of the consequences is that more money, hence larger individual investments, need to be deployed in a world of finite opportunity - unicorns notwithstanding. To begin with, it should be obvious that the term "private equity" has now long been a misnomer. Public offerings for private equity firms have changed the landscape and the description of the discipline.

At the same time, the concentration of capital undermines one of the arguments for taking these private equity firms public: Namely, that doing so helped to "democratize" private equity. This was about making private equity available to a greater range of investors and that the increase in assets would boost the breadth and depth of funding available in an evergreen vehicle across a wide range of private equity funds. Has this promise been kept or has it merely led to larger deal sizes and higher multiples being paid?



These private equity funds would deploy capital targeting different objectives and providing funding within all stages of companies' development and maturity. Just as the public equity market has recently enjoyed a momentum built on technical elements (deep supply of capital) the private equity market will face similar market values borne of technical demand/supply patterns.

Does this amount of increased capital naturally deliver results that are reverting to the mean return that mirrors public equity returns? In fairness, in 2017 the S&P returned 24% and the argument to PE investors has been that on average PE funds would outperform the public market by 6 – 8% over the life of the fund. This comparison is difficult when reliant upon higher multiples of cash flow paid for companies in the current private equity market. Also, the recent tax law changes discourage heavy leverage through the imposition of a cap on the deductibility of interest on corporate debt which could impact returns for buyout focused private equity funds. Thus, more capital paying higher prices on average while compared to a frothy public equity market makes return comparisons difficult between the two asset classes.

Now PE returns are not normally measured in one-year increments but the performance of the private equity funds in recent time would still need to be at least a 20% - 25% IRR net of fees and expenses, over a 3 – 5-year time period to return the size of premium which enables it to be superior to recent public equity market returns. The larger size of a fund may not necessarily correlate to this type of outcome.

None of this is to argue that the big funds don't serve investors very well. They still must perform to retain popularity with institutional investors. Notwithstanding venture capital investment in developing "unicorns", we are seeing private equity funds with a need to employ greater amounts of capital potentially become like other public equity investments.

The large asset gatherers in the financial services industry have usually been associated with the public equity and debt markets. The private equity industry has been institutionalized and is now resembling the merchant banks of yesteryear, except they are SEC regulated now. Whether for good or ill, the concentration of capital may have consequences for private equity's role, its future – and its regulation. Will the SEC continue, for instance, to focus its efforts on retail investors in smaller funds even as large sums of institutional money increasingly concentrates ever more strongly in larger funds?

The implications from this trend for all market participants including sponsors, limited partners, and the businesses they fund are varied and many. The promise of private equity sponsored companies was that they were more strategically flexible and more efficient in instituting change as needed. Now that some of these funds are housed in publicly traded vehicles does that mean that they will turn more short term in their strategic thinking for their private equity holdings (for example doing a leveraged dividend versus redeploying that money into company capital expenditures?) to deliver quarterly results to their own public shareholders?

This type of push/pull in private equity firm decision making requires a short and long term philosophy for each of their investments. Historically, they were concerned with the long term benefits primarily of their strategic direction – has it been compromised in their new public persona?

Some may argue that infusing artificial intelligence into the equation for selecting private equity managers might reveal the flaws and the benefits of the current selection process. Maybe investment advisors of the future will employ such technologies and techniques to ensure better outcomes. The trend line, however, is obvious as more money enters into an asset class it risks the conversion to a commoditized asset. Has private equity begun to go in that direction? It is already arguable if not probable.







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# Brexit: The catalyst for substance over style in asset management

As the phone rings off the hook regarding queries for Duff & Phelps' third party management company services, the European Securities and Markets Authority (ESMA) asset management division is assessing how to elevate the industry to a more harmonized (but potentially less efficient) approach of mind and management in respect of UCITS, AIFM's and MiFID firms. However, there is an increased sense of worry at a European level as to how exactly the post-Brexit asset management and distribution landscape will look.

A May 2017 opinion by EMSA called on regulators to prevent the creation of letter-box entities, and circumvention of regulation by UK firms wishing to relocate and retain the benefits of EU passporting. Via this opinion ESMA wanted to calm all suggestions of regulatory arbitrage to ensure a level playing field for the EU locations vying to become the next European financial centre.

The Central Bank of Ireland issued a Brexit contingency planning letter in November 2017, asking firms to ensure that contingency plans appropriate to each business were being put in place to allow for the various possible scenarios with emphasis on the likelihood of a Hard Brexit.

Then came a series of Stakeholder notices across industries issued by the European Commission, culminating in a notice to stakeholders in the asset management industry on some of the main legal and regulatory repercussions arising from the United Kingdom (UK) becoming a "third country" following Brexit. While the notice acknowledges that there are currently "considerable uncertainties", particularly in relation to a finalised withdrawal agreement and any transitional arrangements that may be contained therein, it is clear in no uncertain terms that the potential impact that Brexit may have on their businesses is seismic. It is evident from the Central Bank's focus on Brexit that now is the





time for firms to start planning. The news that the UK and EU had agreed a longer transitional period to the end of 2020 (which is also conditional on a final withdrawal agreement) does not lessen the urgency of needing to plan for the future.

At the beginning of March 2018, the Autorité des Marchés Financiers (AMF) queried UK-based firms on their status of operations in France and their planning regarding Brexit. It asked how firms were preparing for the loss of an EU financial “passport” and offered them a “direct discussion” over the issue, similar to other regulators, focusing on the challenges Brexit poses to its domestic market. Regulators have now moved from lofty principles to urgent questions of its regulated managers: “What are you doing about Brexit?”

The stark fact is that on 30 March 2019 the EU rules in the field of asset management, most notably the UCITS Directive and the AIFM Directive, will no longer apply to the UK. As a result, UK UCITS management companies and AIFM’s will no longer benefit from the “EU passport” and will in each case be treated as third-country AIF managers. Consequently, those UK entities will no longer be able to manage funds and market funds in the EU on a cross-border basis using their current passport. In order to continue with current activities both managers and funds should consider obtaining authorisation and relocate activities and operations to an EU Member State prior to 30 March 2019.

While at the end of March 2018 we saw some welcome news from the Central Bank of Ireland but only in terms of procedural enhancements related to its authorisation and supervision of Brexit relocation. This means that in the absence of some other arrangements, which given the creeping likelihood of a Hard Brexit, UK managers and funds may be treated like US or offshore managers in Europe.

With the EU passport denied to them as at 30 March, UK businesses will be subject to the vagaries of the National Private Placement Regime (NPPR) in each EU country – hardly a reliable and sustainable EU distribution strategy in the long-term.

So at this time asset managers are faced with coming up with plans for their business post-Brexit, while simultaneously dealing with increased substance requirements around Europe. There is still time and there are a lot of options such as third-party management companies like Duff & Phelps. But among our clients we are now seeing plans being made and ready to execute. The clock is ticking!



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# Client protection at the heart of MiFID II

To create long-term viable businesses, investment firms must provide products that serve clients' needs.

In the majority of cases, even when dealing with a professional client, the ultimate beneficiary of these products is a retail investor. It is therefore incumbent on investment firms to ensure they are providing suitable products.

Markets in Financial Instruments Directive (MiFID) II introduces and strengthens a wide range of conduct of business requirements. First, its product governance framework aims to ensure entities act in the best interests of clients at all stages of the product life cycle. For example, product manufacturers must ensure that, in designing financial instruments, they do not adversely affect the target market or create problems with market integrity. Moreover, distributors are responsible for ensuring the investment offering is compatible with the needs, characteristics and objectives of the client. As a regulated entity, businesses must first consider whether they are a product manufacturer, distributor or both.

Turning to the client life cycle, correct client categorisation remains the starting point to ensure clients receive the appropriate level of service and protection. Communication with prospective and existing clients must be fair, clear and not misleading.

In this regard, as the client relationship develops, MiFID II also introduces enhancements aimed at tackling the risks to the delivery of fair client outcomes. For example, the definition of non-complex instruments has narrowed. This will increase the appropriateness testing that firms must undertake. Furthermore, the MiFID II regulations apply significant changes to the suitability requirements, with a number of the European Securities and Markets Authority (ESMA) Guidelines placed on a statutory footing. Finally, MiFID II introduces new requirements, such as the need to ascertain information from clients regarding their risk tolerance and capacity for loss.





It is important to note that the regulations recognise that investing is not without risk. Firms are not expected to mitigate all risks. Rather, in providing a service to clients, they are responsible for ensuring the level of risk is appropriate to the client and that the client is aware and understands this risk. Taking this a step further, the way firms frame and present their investment offering to a client can greatly influence the client's approach. There is a growing body of work in behavioural economics, and firms should use this to understand a client's needs and risk tolerance, rather than to simply direct clients into products sold by the firm.

The time and money put into preparing for MiFID II have been significant for the industry and regulators. Both should strive to achieve the maximum possible return from this. At its core, MiFID II aims to improve standards of service to clients, increase investor

protection and avoid client detriment. Firms that have embraced the new regulatory requirements should find they are in a stronger position to build long-term, mutually beneficial relationships with their clients.

To prosper over the long term, a firm's goals and its clients' must be aligned. Embracing MiFID II and putting client protection at the heart of the firm's culture will play no small part in delivering this prosperity.



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# The Paradise Papers: The unreported facts

Amidst the publicity surrounding publication of the Paradise Papers last November, some important facts were lost.

In journalists' efforts to make the revelations seem more dramatic than they otherwise would be, that is perhaps inevitable, but it remains regrettable.

First, much of the coverage focused on the names of a few high-profile individuals, whose behaviour (on the basis of expert tax advice) was portrayed as being on the borderline of acceptability, if not implicitly illegal.

Second, by focusing on a very narrow section of the activities of the international finance sector revealed in the leaked papers (which totalled some 13.4 million confidential electronic documents), the media tended to conflate illegal tax evasion and legitimate tax planning. In all the coverage, there was little time given to explaining the important role the international finance, or offshore, centres play in the world economy.

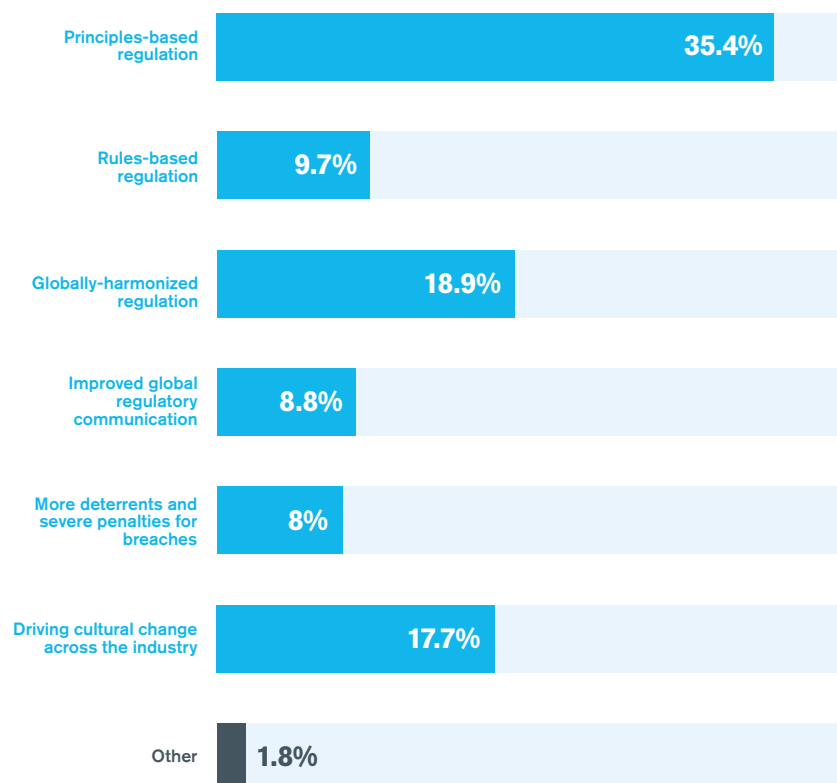
Of course, detailing the many initiatives recently introduced to improve transparency, promote the exchange of information and tackle evasion may not make for the best headlines.

The Foreign Account Tax Compliance Act (FATCA) and the Common Reporting Standard (CRS), measures to tackle base erosion and profit shifting and the introduction of beneficial ownership registers, as well as the U.K.'s Criminal Finances Act, might not grip readers. Nor, perhaps, would good news stories—such as the positive recent MONEYVAL reviews of Jersey and Guernsey's Anti-Money Laundering and Counter Terrorism Financing regimes, or the Organisation for Economic Cooperation and Development's (OECD) assessment of Jersey as a cooperative tax jurisdiction.

Nevertheless, the facts remain, and reputable international finance centres do have an important role as tax-efficient



**OF THE FOLLOWING, WHICH DO YOU CONSIDER THE SINGLE MOST IMPORTANT FACTOR IN MAINTAINING AN EFFECTIVE REGULATORY SYSTEM FOR FINANCIAL SERVICES?**



conduits. Funds (including many of the public's pension funds) are pooled from across the world and invested traditionally in onshore jurisdictions, with those investors paying whatever income or capital gains tax is required by their home revenue authorities.

Of course, public interest and journalistic enquiry inevitably tend to focus on the private tax arrangements of wealthy individuals and businesses. But we should remember the old saying: What interests the public is not always the same as what is in the public interest.

International initiatives and pressure from onshore governments and supranational bodies have already significantly reduced the ability to arbitrage tax regimes across jurisdictions or salt away undisclosed wealth. The fallout from the Paradise Papers will

likely result in further calls for transparency (such as expanding public registers of beneficial ownership) and further tax policy changes—regardless of the reforms already in place. In some cases, this may be warranted, but we should be careful not to undermine the important role international finance centres play, and there are signs we risk doing so.

The key lesson from the Paradise Papers is that firms and their clients must now not only ensure they behave legally but also increasingly—if they wish to avoid censure—have due regard to public reaction should these arrangements be made public. Meanwhile, offshore centres continue to play an important role in the global economy, and many of them are at the forefront of fighting financial crime, a commitment that independent evaluations continue to underline.



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# A reality check

Much has been said of blockchain's potential to transform financial services. One early use has been in cryptocurrencies and initial coin offerings (ICOs). This has gathered massive media attention lately.

As with investors, regulators are still feeling out how to best handle this. Cryptocurrencies and ICOs are a species of blockchain transactions recorded on distributed ledgers. The transactions are virtual yet apparently impossible to manipulate, eliminating the need for banks and other third-party custodians to hold cryptocurrencies or coins that have been transacted in order to safeguard investors' assets or independently verify them. Theoretically, anyone can issue a cryptocurrency or launch an ICO. All you need is access to social media, messaging apps and a fast internet connection.

ICOs are also freely accessible by any investor with access to the same, and financial flows resulting from ICOs can move freely across borders. That means regulation is likely to converge on traditional norms, as national regulators around the world share a common interest in protecting investors in their respective jurisdictions and ensuring the stability of the global financial system.

For all the excitement, then, regulation of this area may well end up looking boringly familiar, with blockchain-related financial services regulated similarly to those housed in bricks and mortar. Materials offered to prospective investors will need to be accurate and complete; anti-money laundering measures will have to be in place; and cybersecurity will be required to protect investors' investments and details.

Already, regulators in the United Kingdom, Singapore, Hong Kong and Australia have issued statements that ICOs involving issuing securities need authorisation and require appropriate disclosures.

For blockchain entrepreneurs, putting controls in place to anticipate regulatory demands and seeking licences to conduct financial services activities will demand resources and potentially slow down speed to market. That will be a challenge for many. With current barriers to entry in the industry being so low, many run very lean operations.





There are two incentives to take a proactive approach, though. First, it is only a matter of time before we see enforcement action against blockchain businesses functioning without the appropriate regulatory status. You cannot “structure out” of regulation, as many may at first blush seek to do, if your business involves conduct of a regulated financial services activity.

Second, low barriers to entry also mean high levels of competition in the industry. Regulatory authorisation and controls to protect investors could prove powerful points of differentiation for those blockchain businesses that embrace them, helping those businesses stand out from the crowd.



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# The SEC looks to the most vulnerable

“It makes me sick.” That was the Securities and Exchange Commission’s (SEC) newly appointed Chairman Jay Clayton’s verdict on retail fraud when he spoke at the U.S. Chamber of Commerce last summer.

“There’s just no room for someone who ruins someone else’s life using the capital markets to do so,” he went on.<sup>1</sup> In fact, though, that’s not true. There’s all too much room; as Clayton noted, the continuing scale of retail fraud is surprising.

Examples are shocking:

- An adviser who raised more than \$6 million from elderly investors, promising to pay their bills, handle their taxes and invest on their behalf, but instead channelled the money to himself, business expenses and friends.<sup>2</sup>
- Boiler room cold callers pressuring senior citizens to purchase penny stocks and telling those complaining to “get a gun and blow [their] head off.”<sup>3</sup>

- Investment scams targeting online dating sites, offering companionship and love—for a modest investment.<sup>4</sup>

Clayton is right to condemn such activity, but he was less vocal on why retail fraud remains so rampant. One key reason is, arguably, the Dodd-Frank Act.

With Dodd-Frank, Congress got things completely backward. It directed the SEC to unregister essentially all small retail investment advisers—those managing \$150 million or less—to concentrate on larger firms. The logic of doing so, in the aftermath of the financial crisis, was to focus on systemic risks to the financial system. The government wanted greater oversight of large institutional investors and, specifically, private fund managers.

<sup>1</sup> <http://videos.uschamber.com/detail/videos/latest-videos/video/5522333805001/a-discussion-with-sec-chairman-jay-clayton?autoStart=true>

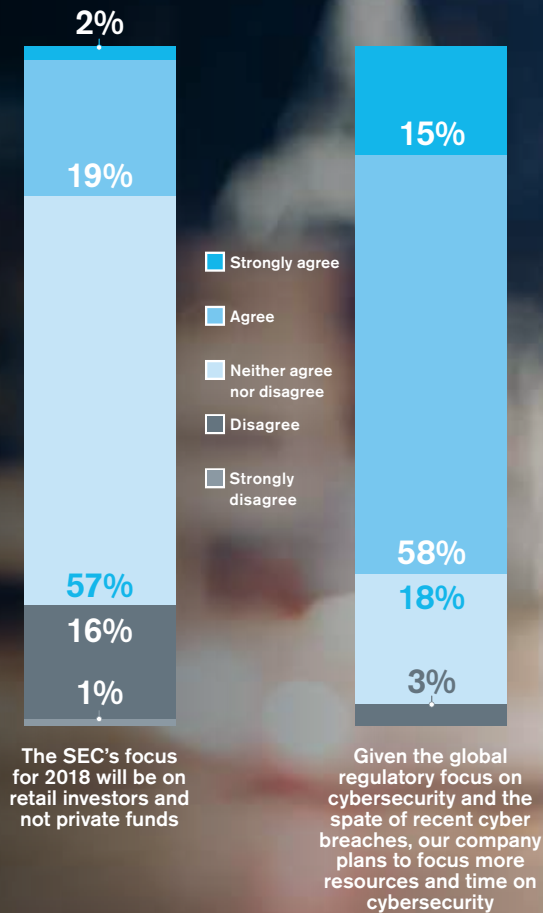
<sup>2</sup> <https://www.sec.gov/litigation/litreleases/2017/lr23995.htm>

<sup>3</sup> <https://uk.reuters.com/article/usa-crime-boilerroom/u-s-charges-14-over-147-mln-new-york-boiler-room-scam-idUKL1N1K327G>

<sup>4</sup> <https://www.sec.gov/news/pressrelease/2016-116.html>



INDICATE THE EXTENT TO WHICH YOU AGREE WITH THE FOLLOWING STATEMENTS:



In fact, it's hard to think of anything done under the Act that has done less to contain or manage systemic risk; rather, activity has focused almost exclusively on increasing institutional investor protection—cracking down on improper allocation of expenses, for example—and other breaches of fiduciary duty.

No one would argue that institutional investors should not be protected from fraud. But, with Dodd-Frank, it was done at the expense of small investors—"Mr. & Mrs. 401(k)," as Clayton calls them. Removing the small advisers who manage their money from federal oversight left them to state regulators, where oversight and enforcement processes are inconsistent

at best and nonexistent at worst. That leaves retail investors dangerously exposed, while conversely, institutional investors can now depend upon the government—in addition to their own sophisticated due diligence teams—to detect fraud, mismanagement and waste.

President Trump was elected promising to dismantle Dodd-Frank. We're not likely to see much material revision to it soon. If the SEC can address its historic mistake regarding retail investor protection, though, it will be an achievement worth noting.



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# What's in a name? It's a question regulators are increasingly asking.

Across the acres of coverage around General Data Protection Regulation (GDPR) and the Second Payment Services Directive (PSD2), some subtleties have been largely overlooked. One of them is the interaction between the two when it comes to the new subject access rights.

Under General Data Protection Regulation (GDPR) and the U.K.'s Data Protection Bill, individuals have the right to access their personal data. Organisations, meanwhile, have an obligation to check the identity of any person making such a request before releasing that data or, indeed, accepting explicit consent to process their data.

Neither GDPR nor the Data Protection Bill currently prescribe how that authentication should be done, only that businesses should log that they have done so "so far as possible," as the bill puts it. It's unclear what that means in practice. We

are working towards an accepted definition of what strong customer authentication may look like. (I'm lead author of the British Standards in Digital Identification and Authentication.) But we are not there yet.

There is one place where standards for authentication are already defined, however: in PSD2. While it may be impractical to fully apply those standards to online retailers or utilities companies, they are the standards expected of financial services. It seems logical, then, that PSD2's authentication requirements will be those applied to financial services dealing





with GDPR.

In the U.K., far from being undermined by Brexit, that's reinforced. Although EU regulations (as opposed to directives) apply directly to member states, the U.K. has sought to promote certainty by writing the requirements of GDPR into the Data Protection Bill. However, the bill is also seeking to align with the Network Information Systems (NIS) Directive, which increases the technical security requirements for critical national infrastructure, such as utilities companies. The U.K.'s approach has therefore seen the tougher standards of NIS leach into its application of GDPR for these businesses.

Payments, though part of critical infrastructure, have an exemption from these requirements, but only on the basis that stronger sector-specific security standards for these companies already exist—in this case, those under PSD2.

The end result is that with the advent of GDPR, all organisations must be able to authenticate customers for the purposes of subject access requests and explicit consent; critical national infrastructure, meanwhile, will have to go further under the NIS rules and employ stronger standards. However, there are financial services companies exempt from NIS because they are subject to even stronger standards under PSD2. But if “best practice” for financial services is required for transactions above 30, surely access to other data, such as medical records or our online profiles, should be at least as well-protected.

It all adds up to a considerable workload facing financial services businesses come May. Many are still getting to grips with the requirements of PSD2, but if security standards, such as the forthcoming British Standard, can have wider application, then there will be additional business opportunities for those organisations that best meet this challenge. Identity as a service could truly come of age in 2018.



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# New guidance from the Trump administration regarding FCPA prosecutions

In December, the U.S. Foreign Corrupt Practices Act (FCPA) turned 40. Just prior to its birthday, Deputy Attorney General Rod Rosenstein announced a new Corporate Enforcement Policy that provides greater clarity regarding the risk of corporate prosecution for FCPA violations.

The policy's goal is to provide stronger incentives for businesses to identify and report suspected violations by individuals. In exchange for offering up corrupt employees and taking other actions that will facilitate the government's investigation, businesses can potentially obtain a declination of criminal prosecution.

As Rosenstein noted, "Law enforcement agencies prosecute criminal wrongdoing only after it occurs. Those prosecutions achieve deterrence indirectly. But a company with a robust

compliance program can prevent corruption and reduce the need for enforcement."<sup>1</sup>

A company must satisfy three criteria to potentially qualify for a presumption of declination of prosecution.<sup>2</sup>

First, a business must voluntarily self-disclose "all relevant facts known to it, including...about all individuals involved in the violation of the law." Such disclosure must occur "prior to an imminent threat of disclosure or government investigation."

<sup>1</sup> <https://www.justice.gov/opa/speech/deputy-attorney-general-rosenstein-delivers-remarks-34th-international-conference-foreign>

<sup>2</sup> In addition to these criteria, to qualify for a declination a company must pay all disgorgement, forfeiture or restitution resulting from the misconduct at issue.





Second, a company must make a timely disclosure of all relevant facts gathered in an independent internal investigation, including those relating to criminal activity by the company's officers, employees or agents. It must disclose relevant facts voluntarily, not only in response to requests by the Department of Justice (DOJ).

Third, companies must take several remedial actions. These include conducting a root cause analysis of wrongdoing, conducting thorough remediation, and implementing an "effective ethics and compliance program," which requires companies to conduct a corruption risk-assessment process and tailor their compliance programs to the key risks identified.

The policy also includes several "aggravating circumstances" exceptions that are potentially broad, including criminal activity by executive management, "significant profit" from the misconduct, pervasiveness of the misconduct and "criminal recidivism."

The new policy reinforces one of the most important indicators of an effective compliance program—namely, a company's willingness to undertake a tailored and thorough corruption risk assessment process and implement and maintain a compliance program that is appropriately designed to address its principal risks.

And as ever, the flip side of increased leniency for companies that "do the right thing" (in Rosenstein's words) is likely to be more severe sanctions for those that don't.

In sum, the DOJ has provided the carrot to encourage businesses to step up their compliance efforts and cooperation relating to the FCPA, and we likely will begin to see the length and shape of the stick over the coming year. The new policy should ensure that the FCPA enjoys a vigorous middle age.

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# Lifting the veil

The more things stay the same, the more they change. In November, the Hong Kong financial regulator published its proposed revisions to the Fund Managers Code of Conduct <sup>1</sup> (FMCC)—a full year after its consultation opened. At first flush, one might wonder whether it was worth the wait.

For many firms, the FMCC merely codifies existing conduct. The main result will be an increase in paperwork, with firms having to document existing policies and practices on leverage, liquidity risk management, custodial arrangements, collateral and so on. Firms have until November 2018, when the new code takes effect, to get them implemented (although work will be required throughout the year to make any required changes, including additional disclosures where required, in offering documentation).

Nevertheless, the code is important for a number of reasons. First, it clarifies the standards the Securities and Futures Commission (SFC) expects of all firms, including both local firms and nonlocal firms, with the latter including those sponsored from mainland China, amongst which standards can be less consistent. The new standards are likely to inform

the “front-loaded regulation” announced earlier in the year by SFC Chief Executive Ashley Alder,<sup>2</sup> who promised “earlier, more targeted intervention” to enable the regulator to “get ahead” of issues. It also is likely to be no coincidence that the amendments and clarifications contained in the FMCC follow closely on the heels of 2017’s Manager-In-Charge of Core Functions, or MIC regime, which seeks to pinpoint responsibility and accountability for actions and controls.

We can probably therefore expect the regulator to come down hard on miscreants to set an example to others and to act as a general deterrent to the market.

The second reason the code is important, however, is particular to alternatives managers and could bring longer-term fundamental change in Hong Kong and elsewhere.

<sup>1</sup> <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/doc?refNo=17CP7>

<sup>2</sup> <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=17PR96>



## INDICATE THE EXTENT TO WHICH YOU AGREE WITH THE FOLLOWING STATEMENTS

Regulators have been effective in establishing consistent global regulatory standards

29%

24%

42%

4%

Regulators are improving their ability to coordinate across borders

1%

51%

25%

18%

3%

Sections of the FMCC apply only to the fund manager “responsible for the overall operation of a fund.” It proposes funds undertake fact-based reviews to identify who this is, but under the guidance it seems likely it would include many Hong Kong advisers of offshore funds.

This arguably makes logical sense. In such cases, it is the Hong Kong adviser who holds the beauty parade for the service providers and partners; it selects the administrator; and it chooses the custodian(s), for instance. The contract may be with the Cayman manager, but it is the adviser in Hong Kong pulling the strings. The SFC’s approach has no legal basis, however. In law, responsibility for appointment rests offshore.

Nevertheless, the move isn’t without consequences.

For a start, it puts pressure on Hong Kong advisers to increase oversight of appointments such as prime brokers—checking not only that they’re creditworthy but also that they are sticking to correct processes. More crucially, perhaps, it inevitably invites others to likewise hold managers here accountable. Disgruntled investors who in the past have only been able to take action against the offshore entity may soon be considering including onshore advisers in any legal action. And where litigants go, regulators in Hong Kong—and perhaps elsewhere—may follow.

The consequences are yet to really be seen, but the SFC has opened the door. Time will tell where it leads.



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# A fool's errand

I've always been excited about the commodities market because it is truly international. As a child, I wanted to travel. As founder and managing director of the Singapore-based manager of a Cayman Islands commodity fund, though, I have to admit travel also has a downside.

In total, our business deals with five regulators across three jurisdictions: the Monetary Authority of Singapore (MAS), since that's where we're based; the Financial Conduct Authority (FCA) in the United Kingdom, which oversees our London subsidiary; the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) in the United States, because of the trading we do there, principally in commodity futures; and the Cayman Islands Monetary Authority (CIMA), because that's where the fund is domiciled.

If nothing else, this has given us a good perspective on the rapid evolution of global financial regulation in the last decade or more. In summary: It's getting more difficult.

When our business was founded, the CIMA had no reporting requirements, the MAS allowed hedge funds exempt status and there was no requirement to register with the SEC or CFTC. (We didn't have a London subsidiary at the start, so the

FCA was no problem.) Since then, and particularly since the financial crisis, the increase in regulatory demands has been relentless, culminating perhaps in the Alternative Investment Fund Managers Directive (AIFMD) and now the Markets in Financial Instruments Directive II (MiFID II).

The tail is not yet wagging the dog; our business is currently upgrading its London office, opened in 2011 as a sub-adviser, to a full alternative investment fund manager, bringing it under the AIFMD regime. Despite the extra work, it still makes sense to do so from a business perspective, though the additional regulatory burden was something the board carefully considered.

Two things are worth noting, however. First, despite talk about it, efforts to promote regulatory alignment between jurisdictions have achieved little. As a result, requirements are duplicated and can even conflict—particularly as regulators increasingly





assume extraterritorial power. We've had situations where, for example, the FCA required us to increase capital in our London subsidiary, but we've been prevented from doing so while awaiting permission from the MAS.

The second point is more fundamental: It's questionable whether this makes anything safer. While hedge fund managers were exempt, investors knew they had only their due diligence to protect them. Licensing, by contrast, provides a false sense of security, and it's no coincidence that all the big scandals have occurred in licensed regimes. Ultimately, all such regimes will have loopholes and blind spots. Investors are never completely safe from the unscrupulous. With that in mind, it is hard to escape the feeling that regulators across the world are all pursuing a goal that is ultimately unattainable.





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# New priorities at the SEC

Politicians are said to campaign in poetry but govern in prose. And so it is that for all the ambitious rhetoric of dismantling the Dodd-Frank Act the principal change to the regulatory regime under the new U.S. administration has been cultural rather than legislative. It may be no less profound for that, however.

In some respects, the approach of the Securities and Exchange Commission (SEC) over the last year represents an evolution of its existing policy. That's most evident in its commitment to transparency, which has only intensified in the last year.

The regulator now publishes not just its exam priorities at the start of each year<sup>1</sup> but also an increasing number of risk alerts and notices on an almost continual basis, as well as seminars, webinars and other initiatives. Its intention is to be as clear as possible with those it regulates about its expectations.

As the director of the Office of Compliance Inspections and Examinations (OCIE), Peter Driscoll, put it in a speech to investment advisers in September: "[E]xaminations are not the only avenue for OCIE to fulfill its mission. As a means of improving and promoting compliance, OCIE has increasingly

added outreach events as a way to educate and engage with the industry."

The hope, he continued, was that increased transparency of OCIE's priorities would enable firms to focus their internal compliance and "anticipate and pre-emptively solve common compliance issues."<sup>2</sup>

But advisers should take note that greater transparency will require firms to proactively monitor and properly address these issues.

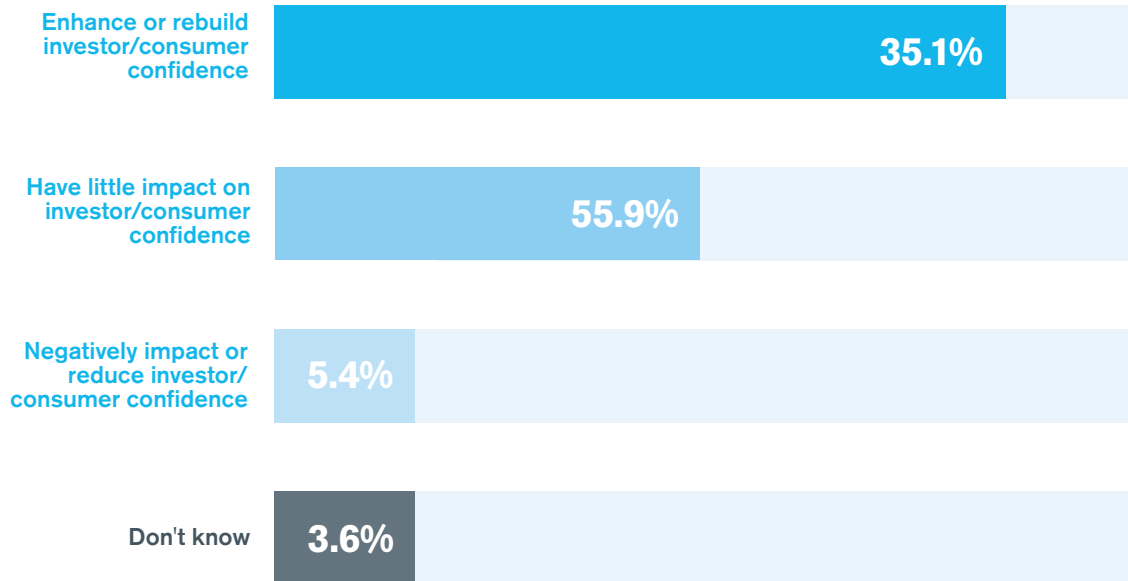
While the commitment to transparency regarding its priorities remains, the nature of the regulator's priorities has changed. Under new leadership, the SEC has abandoned its "broken windows" policy brought in under former Chair Mary Jo White,

<sup>1</sup> <https://www.sec.gov/ocie>

<sup>2</sup> <https://www.sec.gov/news/speech/speech-driscoll-2017-09-14>



**WHAT IMPACT DO YOU BELIEVE REGULATION IN THE FINANCIAL SERVICES INDUSTRY WILL HAVE ON INVESTOR/CONSUMER CONFIDENCE IN 2018?**



which encouraged enforcement action for even fairly trivial compliance failures; “no infraction was too small.”<sup>3</sup>

In October, Steven Peikin, co-director of the SEC’s enforcement division, suggested the regulator was dropping that approach.<sup>4</sup> In its place, new Chair Jay Clayton is focusing the agency on investor protection, particularly for retail investors. The new rule from the SEC is first, do no harm.

Combine that with the emphasis on transparency to pre-empt and avoid enforcement action, and this may well mean fewer cases in the future, as some have suggested.<sup>5</sup>

But it also means the SEC is, first, clearer than ever with its expectations, and, second, likely to come down hard where it sees real wrongs being done to investors. Firms that wilfully or negligently fail to follow its guidance are unlikely to find the new regime has a light touch.

<sup>3</sup> <https://www.sec.gov/news/speech/spch100913mjw>

<sup>4</sup> <https://www.wsj.com/articles/sec-signals-pullback-from-prosecutorial-approach-to-enforcement-1509055200>

<sup>5</sup> [https://www.washingtonpost.com/news/business/wp/2017/11/23/wall-streets-watchdog-is-pursuing-fewer-cases-since-trump-took-office/?utm\\_term=.7211e1807eae](https://www.washingtonpost.com/news/business/wp/2017/11/23/wall-streets-watchdog-is-pursuing-fewer-cases-since-trump-took-office/?utm_term=.7211e1807eae)



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# Alternative data brings different problems

Big data's becoming a big issue for hedge funds and other managers, and it could cause some major problems for compliance.

The case for alternative (or big) data, analytics and artificial intelligence (AI) for investment decisions is increasingly compelling. Even some large managers who have been sceptical in the past are now revisiting the possibilities.<sup>1</sup>

It's not without its challenges, however. In November, a report by the Financial Stability Board (FSB) warned that AI could bring new systemic risks. Applications could result "in new and unexpected forms of interconnectedness between financial markets and institutions," it said, and also stated that "widespread use of opaque models may result in unintended consequences."<sup>2</sup>

A more immediate danger for managers, though, is that their due diligence of data sources and research could be found wanting by regulators.

Examinations over the last 18 months have increasingly looked for evidence that compliance functions can demonstrate a real understanding of every part of the business, including research—do compliance officers know who their analysts are speaking to, where they are getting their data from and whether those data sets are legitimate?

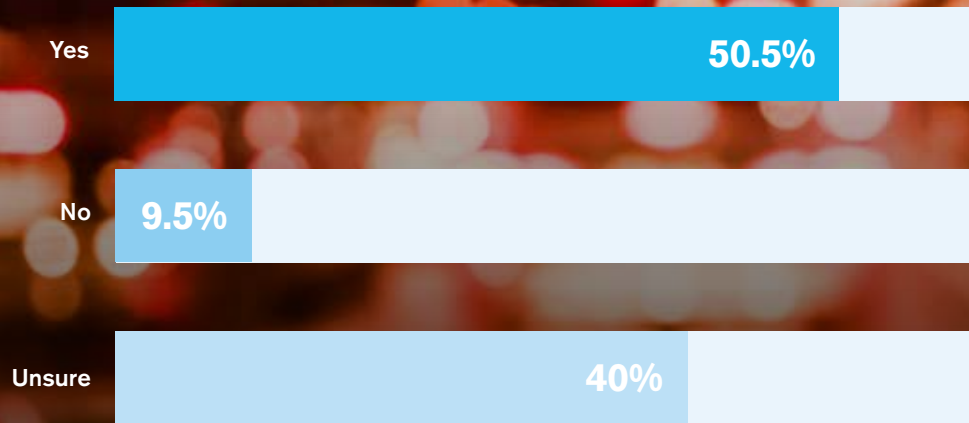
To date, regulatory concern has largely focused on addressing the risks of insider trading, and the Securities and Exchange Commission (SEC) has been improving detection of abuse by enhancing its own big data capabilities, courtesy of the Analysis and Detection Center in the Market Abuse Unit. If firms fail to make checks and ask the questions of their data providers, they could be left carrying the can if the data leads to trading activity that regulators' analysis flags as suspicious.

<sup>1</sup> <https://www.ft.com/content/3a8f69f2-df34-11e7-a8a4-0a1e63a52f9c>

<sup>2</sup> [www.fsb.org/wp-content/uploads/P011117.pdf](http://www.fsb.org/wp-content/uploads/P011117.pdf)



## IS YOUR FIRM ON TRACK TO COMPLY WITH GDPR BY MAY 2018?



And the risks are only going to grow. First, regulatory attention and investment in big data continue to increase. Second, the dangers for managers are not just confined to unwittingly using material, non-public information; there are also increasing risks in terms of data privacy, too.

Managers already face considerable domestic pressure to avoid using personally identifiable information without permission. After May 2018, they must also contend with the European Union's General Data Protection Regulation (GDPR). Any business processing the data of an EU national will be subject to the rules—and the possibility of hefty fines, regardless of where they're based.

If they want to avoid problems, United States businesses—just as those elsewhere—need to start asking some hard questions of their data providers.



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# The price of everything but the value of nothing

Broker quotes and pricing services have long been the Achilles heel of valuation of infrequently traded investments.

A lack of rigour means banks, hedge funds and even credit funds too often accept quotes that don't undergo scrutiny.

No longer. The Public Company Accounting Oversight Board (PCAOB) has come to the conclusion others reached long ago: The emperor may be wearing no clothes.

In its proposed new guidance for auditors on assessing the relevance of pricing information from brokers and pricing services, the PCAOB says it's no longer enough to rely on indicative prices or quotes with limitations. Quotes must reflect actual trades, or a willingness to transact without limiting conditions.

In fact, the considerations where valuations use brokers' quotes or pricing services are three-fold: prices are (i) contemporaneous, (ii) actionable (if a broker) and (iii) congruent—they need to be quotes for trading a similar size, or unit of account, to the holding being valued.

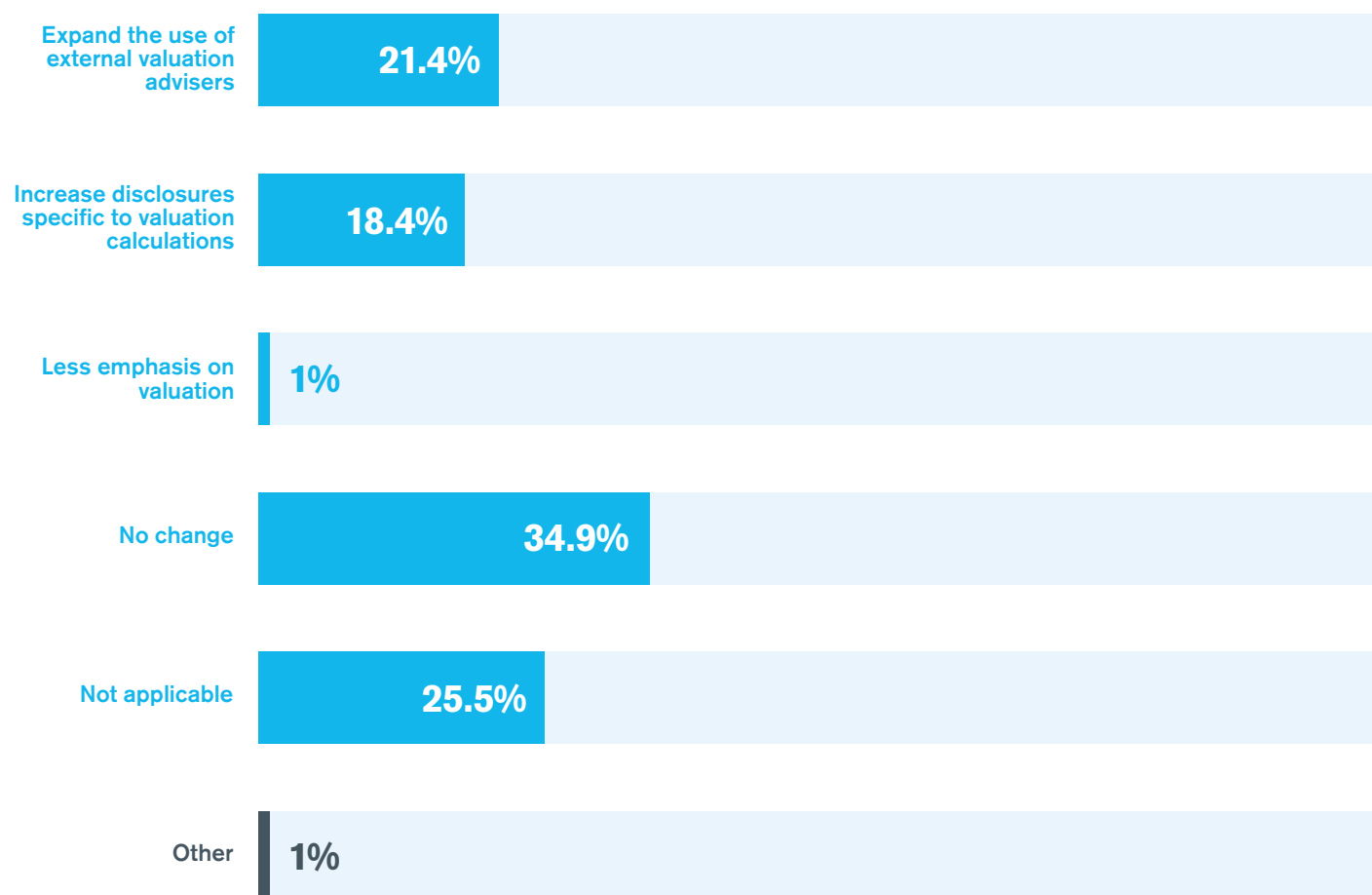
Even where fair values are based on quoted prices or transactions in active markets for the same or similar financial instruments, auditors are required to evaluate the process. Where there are no appropriate recent transactions to support the valuation, the auditor will evaluate the appropriateness of the valuation method and the reasonableness of observable and unobservable inputs used by the pricing service, or, in the case of brokers, whether quotes are timely, binding and without restrictions, limitations or disclaimers.



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IN WHICH OF THE FOLLOWING WAYS DO YOU EXPECT TO ENHANCE THE RIGOUR SURROUNDING YOUR VALUATION PROCESSES IN 2018?

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Effectively, auditors need to see that valuations are based, if not on actual transactions, then on a robust pricing model. Simply taking the broker's or pricing service's word for it won't be sufficient. It will be up to asset holders to provide evidence to the auditor, but brokers, too, are likely to feel increasing pressure from their clients to meet that need.

Furthermore, the impact of the change will also be felt outside the United States, because the guidance will apply to audits of any entities with a Securities and Exchange Commission (SEC) registration, wherever they're based. In addition, it's likely to prove increasingly uncomfortable for auditors in other jurisdictions to continue to blindly accept broker quotes or pricing service data now that the shakiness of their foundations is being exposed.

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# Counting the cost

The theoretical scope for valuation “at cost” in alternatives funds is vanishing as a relief to investors. In addition, noninvestment companies are now expected to report nonconsolidated/nonequity method investments at fair value.

January saw the introduction of the International Accounting Standards (IAS) Board’s new framework for classification and measurement of financial assets in International Financial Reporting Standard (IFRS) 9. Simplifying the complex classification system of IAS 39, an important part of the standard is the clear distinction between accounting for investments at fair value and amortized cost. In most cases, the standard makes clear that fair value is going to be the only option for alternative funds.


This, of course, is part of a wider trend. It follows the U.S. Financial Accounting Standards Board Accounting Standards Update (ASU) 2016-1 in January 2016.<sup>1</sup> Applying to most equity investments, ASU 2016-1 also required measurements at fair value in most cases to be expanded from alternative investment funds to include corporate investments.

In both standards, there are exceptions. Under ASU 2016-1, noninvestment companies can elect to measure investments without a readily determinable fair value at cost. (Investment companies have no exception, as all investments are required to be reported at fair value.) Under IFRS 9, debt investments can be measured at amortized cost if the business model’s objective is to collect contractual cash flows on the assets—provided those investments also give rise on specified dates to cash flows that are solely payments of the principal and interest.<sup>2</sup>

Even where it’s available, valuation at cost will be increasingly rare, however. Under ASU 2016-1, those electing to value at cost have to complete extra steps for assessing impairment, identifying orderly transactions and remeasuring at fair value based on transactions in the security. That may reduce the attractions of the option. IFRS 9 also requires more onerous assessment of impairment for those using amortized cost.

<sup>1</sup> Accounting Standards Update 2016-01, Financial Instruments—Overall: Recognition and Measurement of Financial Assets and Financial Liabilities

<sup>2</sup> <http://www.ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments/>



The real pressure to move away from valuing at cost, though, will not come from the requirements of the standard but the demands of investors, which shaped them.

Institutional investors in alternative investment funds almost universally require reported Net Asset Value (NAV) to be based on the fair value of underlying investments. Institutional investors need fair value-based NAV to determine the fair value of a limited partnership interest for their own financial reporting purposes, as a common basis to make asset allocation decisions, to select investment managers, for performance evaluation and to inform incentive compensation decisions. Furthermore, without consistent and transparent information on the fair value of underlying investments, institutional investors face challenges in exercising their fiduciary responsibilities.

ASU 2016-1 and IFRS 9 have now made it crystal clear that historical cost and amortized cost are not proxies for fair value. With the standards now also clearly making fair value measurement the default, institutional investors' insistence on it will only intensify. Failure to meet this demand won't be without consequence—or cost.





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# A big step towards consistency in fair value

The need for alternative investment funds to report their investments at fair value is long-standing.

For those reporting under the U.S. generally accepted accounting principles adopted by the Securities and Exchange Commission (SEC), fair value reporting has been a requirement since the passing of the 1940 Investment Company Act.

The fair value requirement has evolved considerably over the years, though, and scrutiny has only intensified since the financial crisis. Over the past decade, particularly, the Public Company Accounting Oversight Board (PCAOB) examinations have consistently found exceptions with respect to auditors' assessment of fair value estimates. The SEC, too, has questioned the lack of rigour from registrants providing fair value measurements.

There are several Valuation Professional Organisations that provide credentials for valuation professionals, and the

International Valuation Standards Board has provided global valuation standards. The SEC, however, has remained concerned that many valuation professionals may not adhere to uniform standards for documentation, conduct or quality control.

As the SEC's deputy chief accountant said back in 2011, "Risks created by the differences in valuation credentials that exist today range from the seemingly innocuous concerns of market confusion and an identity void for the profession to the more overt concerns of objectivity of the valuator and analytical inconsistency. The fragmented nature of the [valuation] profession creates an environment where expectation gaps can exist between valuers, management and auditors, as well as standard-setters and regulators."<sup>1</sup>

<sup>1</sup> 2011 AICPA National Conference on Current SEC and PCAOB Developments, December 5, 2011, Paul A. Beswick, as Deputy Chief Accountant of the U.S. Securities and Exchange Commission



Momentum is building to close that gap, though.

First, following consultation papers on auditors' use of the specialists' work and fair value, the PCAOB has proposed new audit standards focused on the issue.

Second, and more immediately, the SEC's concerns have been noted and a new credential established: the Certified in Entity and Intangible Valuations (CEIV) credential,<sup>2</sup> the result of a collaboration amongst the American Society of Appraisers, the American Institute of Certified Public Accountants, the Royal Institution of Chartered Surveyors and major valuation and accounting firms, amongst others. CEIV-credentialed professionals must follow guidance in Mandatory Performance Framework (MPF) documents,<sup>3</sup> detailing the documentation and work required to support fair value measurements.

Over time, pressure is likely to grow on alternative managers to provide fair value calculations that comply with the MPF. Indeed, the MPF documents seem to expect it. While only valuation professionals with CEIV credentials are required to adhere to it, the MPF is explicitly "designed for use by all valuation professionals" and asserts that "adhering to the MPF documents should be considered best practice" in valuation.<sup>4</sup>

While the new standards and credential are still bedding in, that may come to be the case sooner rather than later. The benefits of greater consistency and transparency in the performance of fair value measurements have long been clear. With a solution now finally available to deliver it, auditors, regulators and investors will not want to see it ignored.

<sup>2</sup> <https://ceiv-credential.org/>

<sup>3</sup> <https://www.aicpa.org/content/dam/aicpa/interestareas/fairvaluemeasurement/downloadabledocuments/mpf-for-ceiv-credential.pdf> and <https://www.aicpa.org/content/dam/aicpa/interestareas/fairvaluemeasurement/downloadabledocuments/application-of-mpf-for-ceiv.pdf>

<sup>4</sup> <https://www.aicpa.org/content/dam/aicpa/interestareas/fairvaluemeasurement/downloadabledocuments/mpf-for-ceiv-credential.pdf>



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# Finally addressing forgotten assets

Largely forgotten in the conversation about new developments in illiquid alternative asset investing is the growing amount of aging assets across various strategies.

In 2017, amidst the deluge of articles and anecdotes supporting passive index-focused investing, illiquid alternative asset strategies continued to experience fundraising success, with private equity leading the way. Private equity strategies raised more capital in 2017 than in 2016, and the average fundraise surpassed the previous peak for average fundraising reached in 2007.<sup>1</sup> The alternative assets conversation in 2017 was all about new and next, whether it was Softbank's Vision Fund, Apollo's largest-ever private equity buyout fund or renewed interest in infrastructure strategies.

Largely forgotten in the conversation about new developments in illiquid alternative asset investing is the growing amount of aging assets across various strategies. Globally, there are approximately 3,000 alternative asset funds greater than 10 years old, representing an estimated \$450 billion of net asset

value.<sup>2</sup> Alternative asset fundraising success contributes to this backlog of aging assets, which has more than quadrupled in size since 2012.<sup>2</sup> Investors are attracted to alternatives by the returns, but they are often trapped in aging alternative assets due to the challenges posed by fully realizing a portfolio of aging assets.

Investment holding periods have been rising steadily for the last decade, and managers continue to oversee funds that are well past their operational terms. In many cases, managers of these vehicles discontinued collection of management fees long ago, and investors would like to divest their interests in the funds for managerial and strategic reasons.

As the amount of aging illiquid alternative assets has grown, interest in the secondary market for these assets has increased

<sup>1</sup> Source: Preqin Private Equity & Venture Capital Spotlight—December 2017

<sup>2</sup> Source: Preqin





commensurately. The secondary market for alternative assets has established itself as a useful portfolio management tool, expanding beyond its historical role as a last resort for distressed sellers. Investors have expressed their support for the strategy, driving secondary fundraising to record levels in 2017. As a result, secondary investors possess a record amount of dry powder that is ready to be deployed.

The confluence of record amounts of aging illiquid alternative assets and secondary dry powder presents a significant market opportunity for both buyers and sellers of these assets. And yet, despite the secondary market's growth in terms of size and sophistication, alternative asset managers and investors rarely view secondary market activity as strategic. Financial markets are inherently forward-looking, and older assets often receive minimal attention.

While secondary market activity may not be a top priority for alternative asset managers and investors, there are material benefits to be gained from addressing the growing backlog of

aging alternative assets. Managers of aging funds can (i) create liquidity for their investors through individual asset or portfolio sales, (ii) wind-down legacy funds and (iii) restructure funds to bring in new capital and better support portfolio companies. Investors can divest aging assets to (i) meet investment allocations, (ii) reduce portfolio monitoring burden, (iii) generate needed liquidity and (iv) comply with regulatory requirements. And from initial planning through closing, specialized secondary market advisers stand ready to help sellers navigate transactional, regulatory and other secondary market considerations.

After raising a record amount of capital in 2017, it is anticipated that 2018 will be another strong year for capital deployment by secondary investors. Secondary market pricing, which has been rising steadily over the last few years, will likely continue to improve. In such an environment, managers of and investors in aging assets should consider strategic participation in the secondary market.

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