Regulation in Asset Management
A route to competitive advantage
Acquiring the right talent is the most important capability for 45% of European Asset Managers wanting to expand their business globally.

Risk, Regulations, Diversification and Yield drive institutional investor decisions.

Half of European Asset managers are taking a ‘wait and see approach’ to regulation.

4 in 10 asset managers say they need more local regulatory knowledge to navigate global markets.

70% of asset managers consider that adapting to regulation is making them more risk averse.

Only 17% of organisations consider they are very well prepared to comply with MiFID II.

Increasing regulatory scrutiny is among the top 5 drivers for change.
Introduction

The asset management industry is struggling to cope with the regulatory reform that followed the global economic crisis. The number of rules emanating from multiple regulatory bodies is not the only obstacle managers need to surmount, dealing with the uncertainty resulting from ever-changing regulations is remarkably demanding. In addition to the multi-jurisdictional challenge, national bodies are enacting rules with extra-territorial effects.

It is indisputable that excessive regulation is a barrier for growth, particularly for smaller firms. Nevertheless, the reform of the financial system can also have a positive impact for investment firms. Regulatory pressures have prompted consolidation; moreover, banking rules are making it easier for managers to access business activities traditionally dominated by banks.

Although regulation will have unprecedented consequences on managers’ business models, organisations embracing a sustainable and proactive approach towards the reforms can gain competitive advantage. The adoption of effective horizon scanning can result in implementation synergies, subsequently limiting the strain on financial performance.
Volume and uncertainty

The asset management industry has experienced an exceptional recovery since the global economic crisis; nevertheless, investment managers are overwhelmed by the volume of regulation.

Grant Thornton’s research suggests that as many as 30 investment management legislative initiatives are currently underway in Europe. Regulators’ priorities can, broadly, be aligned to two categories: investor protection and the creation of a safer market infrastructure. The vast majority of regulatory proposals tend to be supplemented by consultation papers and constant reviews. However, the number of new rules is not the only pressing issue for managers, investment organisations agree that the uncertainty surrounding most reforms is the biggest barrier for growth.

For instance, the Financial Stability Board (FSB) and the International Organization of Securities Commission (IOSCO) are considering the possibility of designating investment funds of more than $100 billion as Systemically Important Financial Institutions (SIFIs). The enactment of such a measure would result in higher capital and liquidity requirements. Although the rule is still being discussed and might never be adopted, asset managers need to be prepared for its possible consequences. Despite investment firms operating as agents of their clients and not risking their own balance sheets, the application of measures initially intended for other financial sectors seems inevitable.

Uncertainty is a phenomenon which not only affects projected rules, it also has an effect on regulations already enacted. The Alternative Investment Funds Managers Directive (AIFMD) and the European Market Infrastructure Regulation (EMIR) are two of the most important initiatives in the European Union. However, the different ways in which Member States have transposed the Directive and the phased application of the regulation have caused a great deal of confusion regarding the best method of implementation. Indeed, it is not unusual for rules and guidelines to be open to interpretation which very often leads to duplication and incongruent transposition. The lack of consistency is particularly detrimental for firms operating across borders.

In addition to the increasing volume of regulation, asset managers have to liaise with new supervisors that have increased the scrutiny of managers’ business models. Although establishing and maintaining relationships with these institutions can appear time-consuming, firms must proactively engage with regulatory bodies, both to develop clear understanding of intent and to play an active role in future regulatory developments. The benefits that organisations can obtain from these liaisons are, without doubt, undervalued.

Amount of regulatory information expected to be published in the next year—2015

Source: Thomson Reuters
Multi-jurisdictional Malaise

While the commitment to increase investor protection and financial stability was made at G20 level, the regional and local interpretations of global initiatives have often resulted in complex and contradictory implementation. Despite regulators’ best efforts to achieve harmonisation, the regulatory agenda presents clear asymmetries. Indeed, complying with the torrent of multi-jurisdictional rules is identified by asset managers as one of their biggest challenges¹.

For instance, in Europe, four different regulations – AIFMD, UCITS 5, MiFID 2 and CRD4 – contain precepts on executive remuneration in order to align incentivisation with investors’ needs. Nevertheless, duplication is not managers’ only concern. In a time of fierce competition for experienced leaders, jurisdictions with less restrictive approaches to compensation, such as Asia and the US, have a clear advantage in the war for talent. Indeed, the heterogeneous nature of most rules is prompting regulatory arbitrage, which constitutes an area of deep concern for the FSB.

Asset managers should not only be concerned about the lack of global harmonisation, many national rules have clear extra-territorial effects. The Foreign Account Tax Compliance Act (FATCA) is an anti-tax avoidance measure launched by the US that requires foreign financial institutions to disclose account details of their US clients. Complying with the US government’s requests for information has a profound effect on the way investment firms conduct their businesses; it specifically affects their on-boarding process and their reporting capabilities. More importantly, HM Revenue and Customs estimates that British businesses will spend up to £2 billion in the next five years complying with FATCA. The decision of certain funds to terminate their relationship with US clients is therefore not surprising.

Similarly, investment managers are feeling the effects of regulations that target other financial sectors. As Solvency II reporting obligations increase, insurance clients expect managers to support their new data needs. Investment firms are not legally bound by insurance regulation, yet those that can respond to insurers’ demands will be preferred business partners. Certainly, managers are struggling to satisfy their customers’ changing needs while complying with the surge of regulatory requirements. However, in an industry where client experience is a strong differentiator, only firms capable of achieving a perfect balance will thrive.

Investment firms will need to review their business strategies to ensure that they are aligned to increasing regulatory changes. Although the multi-jurisdictional and extra-territorial nature of many rules draw a complex picture, organisations must seek competitive advantage through ensuring that operational and regulatory change deliver against strategic objectives.

¹ Citibank: ‘Issues facing the Asset Management Industry’

(Source: State Street)
Key regulations impacting the asset management industry

**Undertakings for Collective Investment in Transferable Securities (UCITS V)**

**In a nutshell:** UCITS V is a set of reforms which seeks to bring UCITS legislation in line with that of AIFMD. UCITS V requires funds to appoint a depositary function; it sets out new requirements with regard to managers’ remuneration and seeks to address previous inconsistencies across Member States on sanctions

**Current status:** The regulation will be applicable from December 2016

**Money Market Funds Regulation**

**In a nutshell:** Following an investigation into shadow banking, the European Commission considered Money Market Funds to be systemically relevant and subject to inherent market risks and investors runs. The proposed regulation is designed to ensure that Money Market Funds can better withstand redemption pressure in stressed market conditions by enhancing their liquidity profile and stability

**Who it impacts:** The proposed Money Market Funds Regulation will apply to all MMFs that invest in money market instruments

**Current status:** Proposed

**European Long-Term Investment**

**In a nutshell:** The European Commission has proposed a Regulation on European Long-Term Investment Funds which will create a new brand of fund available for retail and professional investors. The EC proposal comes as a result of the regulatory fragmentation currently challenging investors wishing to gain exposure to long-term assets

**Current status:** Proposed

**Market Abuse Directive (MAD) II**

**In a nutshell:** The MAD directive was launched in 2009 with a view to strengthening and modernising the EU market abuse framework. The EU proposal comprises a regulation on insider dealing and market manipulation (MAR) and a directive on criminal sanctions for insider dealing and market manipulation

**Current status:** MAD and CS MAD are expected to apply from September 2016

**The Fourth Money Laundering Directive**

**In a nutshell:** The Fourth Money Laundering Directive is a European minimum harmonising directive designed to further strengthen the EU’s defence against money laundering and terrorist financing. The Directive is designed to contribute to financial stability by protecting the soundness, integrity and proper functioning of financial services industry

**Current status:** The new regime is likely to come into force in 2016

**Regulatory bodies**

**Global Regulators:**
- G20
- FSB
- BIS

**EU Regulators:**
- European Commission
- ESMA
- EIOPA

**UK Regulators:**
- Bank of England
- PRA
- FCA

**Unregulated Collective Investment Schemes**

**In a nutshell:** Following a consultation, the FSA banned the promotion of UCIS and close substitutes to retail investors other than where specific exemptions apply. The marketing restriction rules aim to ensure that Non-Mainstream Pooled Investments are recognised as specialist products unsuitable for general promotion in the UK retail market

**Who it impacts:** The investments subject to marketing restrictions are: Qualified Investor Schemes, trade life policy investments, units in UCIS and securities issued by Special Purpose Vehicles pooling investments in assets other than listed or unlisted shares or bonds

**Current status:** The Directive entered into force in June 2014. All delegated acts must be transposed into national law by 2016
Packaged Retail Investment Products

In a nutshell: The primary aim of the Regulation is to aid investors to understand information about different investment products and compare them more easily

Who it impacts: It impacts all structured products, securities, funds, deposits or insurance policies, investment funds, OTC derivatives, asset backed securities and convertibles

Current status: The regulation is due to be applicable from mid 2016

Alternative Investment Fund Managers Directive (AIFMD)

In a nutshell: This EU Directive aims to create a harmonised regulatory framework for firms managing or marketing alternative investment funds in Europe

Who it impacts: Managers of all non-UCITS funds, including hedge funds, private equity and property funds with geared assets of more than £100 million or £500 million ungeared

Current status: The transitional period for the application of the directive ended on the 22nd July 2014

Capital Requirements Directive and Capital requirements regulation

In a nutshell: It is a set of major reforms to the EU's capital requirements regulation for credit institutions and investment firms. The primary aims of the reform are to implement Basel III requirements as well as introduce EU specific reforms

Who it impacts: Credit institutions and investment firms subject to local implementation and ‘proportionality’, depending on the size and influence of particular firms

Current status: The Directive and Regulation are enacted

European Market Infrastructure Regulation (EMIR)

In a nutshell: EMIR is an EU regulation covering Over The Counter (OTC) derivatives, Central Counterparties and Trade Repositories. It aims to improve the management of counterparty credit risk and increase trade transparency within the derivatives market

Current status: The Regulation is enacted. First clearing obligations are expected in late 2014

Markets in Financial Instruments Directive (MiFID II)

In a nutshell: The new proposal revisits MiFID with a view to providing consumers of financial products with greater clarity, more thorough reporting and increased ethical standards. It also addresses weaknesses perceived in the previous MiFID framework

Who it impacts: It impacts large parts of the financial services sector including providers and consumers of retail investment products

Current status: The Directive entered into force in June 2014. All delegated acts must be transposed into national law by 2016

FCA review of client asset regime for investment business

In a nutshell: The FCA conducted a wide review of its client assets regime for investment businesses. The aims of the proposals were to address specific risks, clarify the requirements firms must comply with and enhance the client assets regime to achieve better results for consumers and increase confidence in financial markets. The changes include a rewrite of client money rules for investment firms and substantial amendments to custody rules in the Client Assets Sourcebook

Who it impacts: The final proposals cover the entire operation of the client money and custody rules for investment firms that hold client money, custody assets, collateral and/or mandates in relation to investment business.

Current status: The rules will come into force at the end of 2014
Impact on financial performance

The investment management industry is struggling to achieve the level of returns of the pre-crisis era; there is no question that the cost of regulation is exerting negative pressure on profit margins.

The Alternative Investment Management Association (AIMA) estimates that the total economic impact already amounts to more than $3 billion. In order to cope with the array of regulatory demands, firms will need to make substantial investments in information technology, systems and processes. A proactive approach appears to be the only sustainable option.

Organisations agree that the cost of complying with regulations is intrinsically linked to their complexity. For instance, the European Commission estimates that complying with MiFID will have a one-off cost of €512-732 million and an on-going compliance cost of between €312-586 million. Nevertheless, economic predictions are not always accurate. A study projected that the cost of complying with AIFMD would be between five and 25 basis points of assets under management; however, a recent report affirms that the actual cost will only be equal to 2.5 basis points.
The broader impact of regulatory change is harder to quantify. The time that senior management spends dealing with compliance related issues has increased exponentially, diverting their attention from other revenue generating activities. Moreover, as a consequence of the anti-tax avoidance campaign launched by the Organisation for Economic Co-operation and Development (OECD), front office staff have shifted their attention towards Know Your Customer and Anti-Money Laundering activities. Unsurprisingly, many small organisations are in a difficult situation; regulatory change has resulted in an increase of mergers and acquisitions, particularly in Europe where larger managers are in a better position to absorb the costs. The volume of M&A is expected to remain high for the rest of 2014, this consolidative trend is reinforced by banks and insurers disposing of non-core businesses in order to boost their capital reserves. Regulatory expenditure has resulted in barriers to entry for new market participants which will undoubtedly have a negative effect on competition and innovation.

Finally, in a sector where customers are ready to pay more for the services of an organisation with an unimpeachable name, firms cannot afford the reputational costs that a regulatory fine entails. Reputational risks are numerous and therefore difficult to monitor; firms need a clear strategy. Managers spend years building their name, but reputation is so ephemeral that a single event can shred it. Asset managers need a strong culture that can be easily communicated to regulators, and more importantly, to their clients and prospective customers.

The current regulatory environment, nevertheless, presents some unique opportunities for wealth managers. As a result of the pressures to restructure the banking sector, managers are moving into areas traditionally dominated by banks.

Banking institutions are now reluctant to issue long-term loans. Primarily because they need to hold more capital, but also because regulation obliges them to fund long-term loans with long-term borrowing. Asset managers have been fast to respond to the unmet demand. They mainly act as matchmakers, all the proceeds and the losses from the loans go to investors, the firm simply administers the portfolio of loans and charges them a fee. According to a recent publication, investment funds raised $97 billion for lending over 2013. Other banking rules, such as the prohibition of trading on their own account or those that are diverting the trading of derivatives onto public exchanges are reducing banks’ dominance.
Governance

The aftermath of the global financial crisis highlighted some fundamental governance failures. Since then, asset managers have been subjected to increasing scrutiny not only from regulators but also from a new breed of risk-averse investors.

The roles of boards and executives are undergoing profound changes, their oversight responsibilities have been dramatically extended. Boards are now required to provide an extra layer of assurance to safeguard the organisation and its reputation. Consequently, the qualifications of its members are now a crucial matter and the process of due diligence before their nomination has been substantially enhanced. The role of board members has changed significantly; they need to be actively involved and assume the responsibilities that their position entails.

Policy-makers are particularly concerned about the long-needed cultural change and certain categories of risk, especially conduct. In order to ensure fair customer outcomes, organisations need to manage the inevitable conflict of interest between clients’ profits and fund returns. Boards must set the tone from the top to ensure that values are effectively communicated and understood. Personal accountability remains a pressing challenge.

In the UK, the FCA has stated on various occasions that holding senior decision-makers personally accountable for their choices is the most powerful way to encourage the right behaviour. Following a proposal from the Parliamentary Commission on Banking Standards, the Regulator has replaced the Approved Persons Regime with a Senior Managers Regime. The new system only covers those individuals that are, in effect, senior decision-takers. All applications to perform such a function will be accompanied by a ‘supplement of responsibilities’ listing the affairs of the firm for which the individual is responsible. Furthermore, a criminal offence for ‘reckless misconduct in the management of a bank’ has been created and those found guilty could be sentenced to up to seven years and/or an unlimited fine.

While the Senior Managers Regime is only applicable to deposit-taking institutions, Mark Carney, governor of the Bank of England, recently declared that senior managers within the insurance industry will soon face new levels of accountability: “Integrity, honesty and skill are not optional, whether you run an insurance company, global investment bank or building society”. The extension of the regime to asset managers seems inevitable.

Stronger internal controls and greater transparency are not only mandatory regulatory requirements, they are also essential to attract institutional investors. For instance, in Europe, it is not unusual for pension funds to require a strong board and governance structure before they invest in a fund. Enhanced and more transparent Management Information will countenance decision-making. Additionally, a clear definition of roles and responsibilities, will be essential to achieve an optimal organisational structure and a way for investment firms to distinguish themselves from their competitors.
The importance of a proactive and sustainable approach to regulation

Given the unpredictability of the regulatory panorama, it is unsurprising that more than fifty per cent of European managers have decided to adopt a reactive attitude towards regulatory change⁴.

Nevertheless, the tendency to focus on imminent regulations often results in isolated, costly and ineffective change initiatives which can easily lead to strategic stagnation.

At a time where compliance is exerting great pressures on asset managers’ profits, it is essential to address operational and change-related inefficiencies. The establishment of a set of tools and processes to facilitate a single, firm-wide view of the regulatory agenda is at the heart of proactively and sustainably managing legislative changes. Furthermore, instituting a golden source of regulatory information will both inform change teams and guarantee effective monitoring and reporting.

Progressive organisations must embrace the current challenges as an opportunity to initiate radical changes; an assessment of the viability of products and business lines seems natural. Smaller firms have started to focus on niche products where they can be market leaders. Others, have decided to target specific client segments. However, it is essential that such significant decisions are based on a holistic understanding of the regulatory landscape.

A recent study⁵ highlighted that European managers could make an extra billion pounds in annual profits if they took advantage of some of the dispositions of UCITS IV. In 2011, the Directive introduced a passport for UCITS management companies that permitted funds to be managed on a cross-border basis without needing a separate company in every country. Since branches are not as costly as independent organisations, firms could be saving up to 20% on legal bills and reduce their governance costs by €200 million. Nonetheless, many managers viewed the regulation as a burden rather than an opportunity, and because it was not compulsory, decided not to implement it.

It is imperative that firms underpin their decision-making with a reliable foundation of information from which to base strategic and commercial decisions. This is particularly important for those asset managers wanting to acquire other companies or establish new operational centres abroad where local regulatory expertise is needed.

Increasing internal awareness and understanding is a core component of establishing a culture of regulatory awareness.

Firms that incorporate compliance in their overall business strategy and understand the importance of adopting a framework that promotes a firm-wide view of existing and projected reforms will be those to succeed.

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¹ Bank of England: “Regulating the insurance industry to support the real economy”
² State Street: “The Changing shape of European Investment Management”
Challenges for the compliance function

Compliance teams have historically been responsible for identifying regulatory changes and requirements; however, they tended to implement rules individually and prioritise according to the nearest deadline. This ‘wait and see’ attitude is no longer suitable to deal with the plethora of multi-jurisdictional regulations and satisfy customers’ needs; moreover, as stated, it is highly inefficient from an operational point of view.

In an environment where pragmatic implementation, as opposed to absolute adherence, is not an option, regulatory compliance needs to evolve beyond a simple check box exercise to a proactive and fully integrated function. However, compliance departments have not been structured to deal with changes of such a magnitude. With salaries increasing around 17% year on year, experts sustain that the strong demand for compliance professionals has triggered a war for talent. Having the right people provides a great competitive advantage; senior executives and Human Resources departments must acknowledge this challenge and integrate their long-term business and talent strategies.

Compliance teams that spend more than 10 hours a week studying regulatory developments

Source: Thomson Reuters
A recent survey revealed that the biggest challenge for heads of compliance in financial services organisations is tracking new legal requirements and implementing them across the business. Indeed, in many international firms, legal teams operate in silos; the avalanche of new monitoring and reporting requirements renders the coordination of regulatory change programmes nearly impossible. Organisations wanting to manage regulation proactively need a single source of regulatory information.

Given the increasing demands that compliance functions are facing, progressive managers need to consider whether their compliance framework is capable of satisfying new conduct and cultural demands. It must not be forgotten that regulatory compliance is not an exclusive task of the compliance team. In order to be effective it is essential that it is fully integrated into day-to-day business operations. More importantly, in order to mitigate the current strain on resources, teams within the first line of defence must understand and contribute to routine monitoring.

Compliance risk management is a collaborative process that should leverage various control functions. A collective approach would help eliminate duplication. Furthermore, the establishment of a business architecture and governance model that informs and guides impacted parties will be at the heart of achieving regulatory compliance.

The development of a firm-wide single view regulatory dashboard is fundamental to implementing a more proactive approach to regulatory management. Increased awareness and understanding will foster both long-term planning and a culture of regulatory responsiveness.

With the implementation of transaction reporting requirements in the UK, such as MiFID and AIFMD, the FCA has made it clear that it will heavily monitor trading activity.
Conclusion

The asset management industry faces a period of transformation. Nevertheless, there are exceptional opportunities for those organisations willing to fill the numerous gaps left by the banking sector. Regulatory change must not be viewed solely as a burden; as UCITS IV demonstrates, it could also help firms achieve operational efficiencies and gain competitive advantage.

Investment firms will continue to face a multitude of challenges, with multi-jurisdictional and extra-territorial issues to the fore. In spite of this, those managers that adopt a proactive and integrated approach to regulatory change will realise significant efficiencies through the identification of regulatory synergies.

Regulatory awareness and understanding will be critical to a proactive approach. Greater regulatory awareness and understanding will not only facilitate long-term planning, it can also result in huge economies of scale. Moreover, compliance teams will be able to focus on pressing mandatory reporting and monitoring activities and therefore reduce regulatory risk.

Grant Thornton contends that the influence of the regulatory agenda will assert ever greater pressure on businesses’ strategies. Consequently, the need for expert regulatory guidance and representation at C-level will become irrefutable. Indeed, those organisations that are able to integrate their business and regulatory strategies will be those that position themselves best for sustainable and compliant growth.

In conclusion, Grant Thornton proclaims that investment firms who adopt and embed business models that actively manage cross-functional regulatory change as part of an integrated business strategy will achieve viable competitive advantage.
The development of a firm-wide single view regulatory dashboard is fundamental to implementing a more proactive approach to regulatory management. Increased awareness and understanding will foster both long-term planning and a culture of regulatory responsiveness.