Thought leadership - Are asset managers better to sail with a co-pilot through the regulatory challenging waters?

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Since the global financial crisis the European funds industry has been subject to a wide body of new legislation **designed to promote investor confidence, to enhance levels of investor protection and to broaden access for investors to transparent, affordable products that meet their investment objectives.**

The European Commission has, at the same time as trying to ensure that collective investment funds **remain attractive as a savings vehicle**, sought to ensure that the **European funds industry remains competitive globally**. The UCITS brand has been valuable in enabling European asset managers to market their funds outside Europe, into Asia and Latin America. But the Commission is well aware that competition from other fund markets is always likely.

So there is much going on that is intended to make the funds industry a safer, more transparent and more efficient place for people to invest for their long-term futures. But this is also creating **a huge level of change for the investment management industry** with significant costs involved in adapting to, and complying with, these reforms.

Confronted by these challenges, asset management companies – whether managers of traditional collective investments or alternative investment products – **need to conduct a thorough appraisal of their business strategies** in this changing environment and also give careful consideration to how they will manage the costs of change.

Managing the reform agenda

For alternative investment managers 2014 was the year of AIFMD. In the next 2-3 years the funds industry **will be challenged by a further cavalcade of new legislation** including UCITS V, EMIR and MiFID II. Few except the very largest asset management houses will typically have the **internal expertise** to manage these changes wholly in house, particularly given the tight schedules that have been mapped out for implementing these reforms.

MiFID II is likely to be the major game changer for asset management companies active in the EU over the next three years. It will **force investment firms to conduct a thorough review of their internal governance**, fund manufacture and distribution strategies – and it will also demand significant changes to their trade analysis and reporting mechanisms.

With the implementation of MiFID II, the number of data points that firms will **be required to include in their transaction reporting** will increase dramatically – requiring **that firms complete upwards of 81 data fields** when filing their trade data reporting to financial regulators, compared with 24 data fields under the current MiFID regime. This trade reporting process may be further complicated by the fact that EU Member States **have failed to agree on a standard identification methodology for individuals and organisations**, meaning that different markets may employ different identifier formats. In some cases identifiers may not be unique, or may need to be renewed periodically in a similar way to an identity card or passport.

Asset managers are addressing these challenges in different ways; some asset managers **may draw on their fund services partners to support them with a wide range of functions** across the transaction value chain ranging from dealing services that are significantly impacted by MiFID II to fund administration and regulatory reporting. Other asset managers **need assistance** with just selected components across this value chain, again seeking support from their fund services partners.

In fact, this type of service partnership can play a **key role in helping asset management clients to manage the complexity** presented by a wide range of these regulatory changes. For example, under Section 871(m) of the US Internal Revenue Code, non-US investors in products that have US equities as an underlying instrument will be subject to **withholding tax**, payable to the US Internal Revenue Service, when dividends and other entitlements are paid on the underlying equity. For financial intermediaries acting on behalf of these investors, this presents a **major challenge in monitoring**, and reporting to the IRS, taxable income that may be due under this piece of legislation.

Global distribution

Asset managers face challenges in the distribution of their products. **Cross-border fund distribution has expanded into new locations** over the past decade, with international asset managers employing a UCITS wrapper to market their flagship fund products cross-border within the Asia-Pacific region and parts of Latin America.

For non-EU asset managers, a range of options are available that will enable them to extend their distribution reach in Europe. Some firms have elected to establish their own UCITS Management Company in an EU Member State**, thereby enabling them to take advantage of the passporting rights** under UCITS in order to distribute throughout the EU and beyond. However, for those firms that do not wish to incur the cost and administrative challenge of establishing their own bricks-and-mortar fund management presence in an EU member state must look for a

management company within Europe to enable them to launch funds, UCITS or AIFs, and to market these across the European Economic Area.

Reporting is more onerous

The generation of investor reporting, traditionally considered a core activity by many asset management companies, is now **being partially or completely outsourced** in order to allow the asset manager to focus more closely on activities which are truly core, notably, asset allocation, risk management and managing investor relationships. Any tool that simplifies the work of their fund distributors is seen to **provide a clear benefit for their distribution workflow.**

The demands of investor reporting are increasing, with investors seeking assistance from their asset management companies in meeting their own regulatory or tax reporting commitments. For some asset owners this may represent a simple request for the data needed to compile the reports themselves; for others, this may be a request for **more comprehensive assistance** in preparing and submitting necessary reporting. For example, insurance companies will be required **to comply with the Solvency II directive** from 2016. But Solvency II is only one of the numerous regulatory reporting commitments that regulated businesses are facing and, as we have seen, this is having a ripple effect through to asset management companies.

Beyond reporting

The impact of new regulation extends beyond reporting. The collective impact of the European Market Infrastructure Regulation (EMIR), the Dodd Frank Act, Basel III (CRD4), Solvency II and the Markets in Financial Instruments Directive II (MiFID II**) is changing the landscape of financial markets**, requiring participants **to adapt their strategies**. For example, the combined effects of this legislation are likely to **generate a sharp rise in demand for high-grade collateral** during the next two years, particularly as a result of Basel III capital requirements and margining requirements for OTC derivatives cleared via central counterparties – which, for some investment firms, will compel them to operate in a central clearing environment for the first time.

This development may lead to an **increase in demand for collateral** simply because, currently, many entities use a **single counterparty** for OTC derivatives trading that requires only that they post **collateral against their global net position**. With the progressive shift to central clearing, use of a clearing house may have a “de-netting” effect that results in a rise in the aggregate capital required to collateralise this set of positions.

Regulation may have other consequences. Within Europe, some **asset management companies are also seeking to reorganise their corporate structure and distribution frameworks for strategic reasons**. With introduction of Financial Transaction Tax (FTT) in the certain markets, for example, some asset management companies that previously marketed UCITS or AIFMD funds domiciled in some locations **have taken the decision to relocate** selected funds to Luxembourg or other EU Member States in order to reduce their FTT liability.
Coping with these new requirements will **create a need for firms** to enhance their processing capabilities, to manage the associated costs and to **refine their funding strategies**.*

With so much change and complexity on the horizon, we believe that we are moving into a period where the **investment funds industry is changing fundamentally**. Asset managers will look at the services they undertake in-house and assess the value of those services; they will **restructure to suit the new environment and requirements both from regulators and from their clients**; but overall, what we’re seeing in the industry is that asset management companies, whether traditional or AIFs**, are focusing on what they do best: manage assets for their clients**. We see a sea of change in the industry and it’s important that asset managers have a strong partner to pilot them through.