Fund managers are faced with a tide of new regulations: It is important to have a clear understanding of the risk, cost and operational implications.

It is easy to forget, but there was a time when new regulatory initiatives in the fund management area were predominantly aimed at harmonizing markets, encouraging competition and improving efficiency. Today, the thrust is very different. Since the financial crisis of 2008, governments and regulators alike have shifted their full focus on systemic soundness, enhanced oversight and increased investor protection.

Industry input has had limited reach regarding the outcome of regulation recently and in some cases there is uncertainty over how the new rules will be applied. For fund managers, this makes it even more difficult to navigate a maze of increasingly interconnected regulations (see Mind Map on page 34) which continue to multiply as more G20 countries join the U.S. and the EU in rewriting the rulebook.

There are three key areas of impact that the industry must keep in mind:

• Cost
• Risk
• Operations
Cost
For all firms there is a considerable up-front cost in preparing for the relevant changes. That, however, is just the start. Several factors are set to impact operating costs on a continuing basis:

- Basel III imposes higher capital requirements on service providers and more stringent collateral management requirements for asset managers. By tying up capital that would otherwise be used to generate revenue, this imposes a permanent cost increase.
- Provisions within Basel III relating to bank lending to hedge funds look set to increase funding costs and some trading costs.
- The shift to central clearing of most OTC derivatives under EMIR (in Europe) and Dodd-Frank (in the U.S.) will necessitate the posting of increased amounts of collateral as both initial and variation margin. It will also add materially to the operational challenges (See Operations over page).
- The AIFMD inverts the burden of proof in the event of any loss of financial instruments onto depositaries, requiring them to make restitution without undue delay and only then prove that they are not liable in order to recoup the loss. “This fundamentally changes the business risk profile of the depositary or safekeeping function,” says Natalie Westerbarkey, Director, Client Executive at Citi Transaction Services.

In addition, the European Commission Level II draft text requires depositaries to treat third parties – such as brokers appointed by a hedge fund, collateral agents or central counterparties (CCPs) – as delegates of the custody function. This would make the depositary potentially liable for any loss caused by those third parties.

“Increased liability and hence business risk of safekeeping is likely to be factored into prices industry-wide in order to mitigate these,” says Ms. Westerbarkey. UCITS V is expected to incorporate similar depositary liability rules, pushing up the cost of safekeeping for all investment funds managers including mutual funds distributed to the retail sector, not just hedge funds.

- The Commission’s draft of the AIFMD introduces new restrictions on the extent of activity a hedge fund manager can outsource. In an analysis of the recent text, the Alternative Investment Management Association (AIMA) commented: “If implemented, the vast majority of EU-based funds and managers would have to significantly restructure their business without any apparent benefits to investor protection.”

The costs in these various areas are hard to quantify at this stage, though AIMA last year estimated that the AIFMD alone would cost the alternative investment industry $6bn a year. Simon White, COO of Man Group says: “I have seen estimates ranging from 20 or 30 basis points to in excess of 1%.”

Risk
The sheer volume of new legislation and the interconnected nature of different regulations represent a daunting compliance challenge for even the biggest, and best resourced, fund management companies. Global organizations will find themselves tackling parallel initiatives on several continents at once. There is reputational risk if firms fail to meet relevant deadlines or misjudge their response in areas where ambiguity remains. Two examples:

- MiFIDII now impinges on the UCITS rules by classifying structured UCITS (e.g., guaranteed products, those with predetermined dates, algorithmic payoffs) as complex products – and therefore subject to new transparency rules in the sales process. Fund managers need to identify which of their products will now be covered by these rules and how they may be distributed, says Ms. Westerbarkey: “The problem is that while structured and unstructured funds are defined in the legislation, there are issues of interpretation that may lead to uncertainty in practice.” The outcome in practice: If in doubt, classify a product as structured to limit in particular reputational risk. The reform is targeted to come into force in July 2015.

- Firms will have the option to sign up to FATCA from January next year. Given the international cooperation agreement between the UK and the U.S., many UK-based firms
are hoping they will only be required to report to the Financial Services Authority rather than the U.S. Internal Revenue Service (IRS). However, if a manager has operations in another country that has not signed an equivalent agreement on FATCA (such as Switzerland, Ireland or Luxembourg), they would be well advised to prepare for compliance arrangements with the IRS directly.

**Other deadlines are looming:**
- The first deadline for compliance with the AIFMD is just over a year away. Funds need to select and onboard a depositary and put appropriate reporting processes in place vis-à-vis regulators and investors.
- In Europe, firms must be ready for the move to central clearing of OTC derivatives by the end of this year – with all the collateral management capabilities that this implies.

EMIR and Dodd-Frank aim to mitigate risks, but some consider they also introduce additional, new risk for the financial services industry. By replacing multiple counterparties to OTC trades with a limited number of CCPs, many firms’ risk exposure will be concentrated on one or two counterparties. “CCPs typically mutualize risk and the new governance framework of CCPs mandated by EMIR is designed to be very robust,” says Ms. Westerbarkey, “but the central clearing of this asset class at such significant scale is an unproven concept. OTC derivatives have a fundamentally different dynamic in terms of financial risk to equities, so it will be critical to be prepared for all possible scenarios.”

**Operations**
The operational implications of the new legislation are far-reaching. They touch not only the compliance and middle-office functions but wider strategy issues too. There are three key areas:

- The move to central clearing will place new demands on all firms. At its most basic level, the change obliges fund managers to put clearing and collateral management capability in place – not only to deal with contracts traded on-exchange and cleared centrally but for those still traded on a bilateral basis. But it should also make them review their product and investment strategy. “Firms will have to determine which products have the higher potential of success in terms of returns and investor demand,” says Ms. Westerbarkey: “This is a crucial question as asset managers weigh up trading derivatives on-exchange, off-exchange and cleared bilaterally or via a CCP as it pertains to the balance of cost and returns.”

- For hedge funds, the new risk reporting requirements of the AIFMD will ask more than ever of the middle office. There is a big challenge to be ready in time. But as the benchmark on risk reporting rises, so investors expect to see ever more sophisticated processes, built around daily reporting and independent valuations. “This used to be a ‘nice-to-have’, but now it is becoming the norm,” says Ms. Westerbarkey.

- Most hedge funds and private equity funds that are active in the U.S. must now be registered. They also need to put appropriate compliance and risk management policies and procedures in place and ready themselves for Form PF regulatory reporting, the start dates for which depend on a fund’s size and activities. Bruce Treff, Managing Director, Head of U.S. Fund Services, Citi Transaction Services, says: “Firms must build a compliance infrastructure, test it and document their compliance.” The compliance program must be reviewed at least once a year.

Firms need operations people who have not only mastered the new regulatory requirements but understand how they may impinge on business strategy over the longer term.

**Citi’s readiness...**
At Citi, we have an integrated suite of services to help firms meet the demands of the new regulations:

- As a member of virtually every CCP worldwide – and the EU and U.S. in particular – we are the only provider with a tried and tested, end-to-end global solution spanning derivatives trading, clearing, collateral management and settlement also at the Transatlantic level.
• Our unrivaled proprietary custody network in the local markets gives us a key advantage and necessary expertise in assuming the new responsibilities placed on depositaries under the AIFMD, together with the ability of mitigating risks across a diversified business globally.

• We deliver middle-office services on an end-to-end or modular basis, allowing clients the flexibility to determine their own service requirements.

• Citi’s Middle Office Monitor is a market-leading portfolio risk-reporting service, featuring a Risk Metrics engine to deliver timely, accurate and highly granular reporting.

In all these areas, we offer cutting-edge solutions — and we offer them on a consistent, worldwide basis. We actively anticipate change. Our investment in product enhancement is nonstop, and much it is focused on delivering solutions that cut through the complexity imposed by regulatory change. Whatever the risk, cost and operational implications of adapting to the new regulatory environment, Citi is ready to help its clients respond effectively.

“We are also engaging closely with regulators in all the impacted markets and working with market counterparts to present joint positions to the market authorities. We have had some success in getting a market-wide view established,” he says.

At a business level, plans have been developed to cover all front-to-back activities, starting with custody, which plays the vital role in generating the information flows to funds services. “We have full playbooks in place for all four scenarios, covering everything we do for our clients both through our direct and global custody services,” says Mr. Smith. “Those playbooks can be activated at a moment’s notice, assuming the local custody platform is operating correctly. That will then feed up into the global custody platform and then on to our funds services business where, again, we have full playbooks in place to enable us to cut NAVs appropriately, both for our long-only and alternative client base.”

A similar playbook has been developed for securities finance — both from a risk and operational viewpoint. It relies on the underlying securities process and encompasses the collateral platform. On the issuer services side, where Citi acts as paying agent for bonds or ADRs, issues will be dealt with on a case-by-case basis and will be dependent on the direction the issuer adopts. “There is likely to be a lot of legal work where we are paying agent on a specific bond,” says Mr. Smith.

Subject to legal confirmation, the working assumption is that a default, whether chaotic or orderly, will be treated as a mandatory corporate event. It will be processed at the normal operation center — as was the Greek PSI restructuring. If required, Citi has the flexibility to draw on the regional asset servicing team and can move resources as required. A full review of all relevant assets in custody has already been completed.

Dealing with redenomination
“Redenomination is more challenging,” notes Mr. Smith: “It would be unprecedented in legal terms. Without knowing the premise on which it will work it is difficult for us to have a full contingency plan in place. The time frame for a chaotic redenomination is also likely to be short.” Citi’s response has been to implement a technology solution to help manage a planned redenomination, while readying manual processes to support a chaotic redenomination in smaller markets, such as Greece, Ireland or Portugal.

Technology processes are also being implemented to support larger markets in the event of a chaotic redenomination. All branches have reviewed their resource availability and put plans together for regionally reallocating resources — including drawing on Citi’s regional processing centers in Dubai, Tampa, Florida and Singapore.
It is currently assumed that existing accounts will be redenominated in a new currency and SWIFT has made it clear it will not be reusing old currency codes. Citi is working on the assumption that new securities will be issued for government debt while equity ISINs will remain unchanged.

Funds services will follow the same process outlined for custody. A redenomination tool still exists from the last conversion process and is being tested. Securities loans and collateral will similarly go through the redenomination process laid down for custody.

On the cash side, a big increase in new account opening activity has been built into Citi’s contingency planning. “We anticipate a large volume of new accounts being opened by people who also want to retain their old account,” says Mr. Smith.

In-flight transactions
One big area of uncertainty remains — and it is one which investors, as well as custodians, need to consider. Were a government to exit the euro over a weekend, without prior notice, it could leave transactions executed on the Friday but due to settle on T+1 or later in limbo. “What to do about such in-flight transactions is one of the unanswered questions,” continues Mr. Smith: “Would a government announcement to exit the euro change what instructions are out in the market? Could investors themselves change their instructions?”

Citi’s view is that in-flight deals would either need to be rebooked in the new currency or cancelled on a deliver-free/receive-free basis so that the euros could be moved offshore. However, much would depend on local regulations. “This needs airing now,” says Mr. Smith: “Without a consistent approach, the risks will increase. We would like to hear our clients’ views, as well as those of our industry peers.”

Maintaining good client communications in the event of a chaotic default or redenomination will clearly be key. “There is bound to be a surge in the level of enquiries from clients and we are working on ways to ensure we can maintain open communications and maximum transparency,” says Mr. Smith.

Citi is also working actively to help establish industry working groups to agree a common approach. A cash and trade body is already in place and will act as a coordination point for all banks in the event of a crisis — much as the Heathrow group did during the implementation of the euro. One meeting of a post-trade securities processing group has also taken place.

That, however, still leaves unanswered questions over the readiness of some market infrastructures to cope with a chaotic redenomination. “We have had discussions with all the relevant value transfer networks,” says Mr. Smith. “All have thought about the issues, but not all have detailed contingency plans in place.” This is a concern: A systemic change of this nature would normally take months to implement.

Citi, however, is as far down the road as it can go at the present time. “We have identified external and internal counsel, which are ready and committed to Citi to review legal implications of any announcement,” says Mr. Smith: “Where we can, we have started legal discussions on some specifics, such as the in-flight transaction issue.” With the strengths of its global custody platform and regional processing teams to draw on, Citi is ready to rise to the challenge of default or redenomination, whether planned or chaotic. “Whatever bumps there may be in the road, we are committed to smoothing the path for our clients,” ends Mr. Smith.
INVESTMENT MANAGEMENT – REGULATORY ECOSYSTEM

Key Regulatory Reforms for Asset Managers

FATCA
U.S. Foreign Account Tax Compliance Act

Timeline
• Signed into law in March 2010
• Effective from Jan 2014 for FDIP; from Jan 2017 for pass-through payments

Key Themes
• Rationale: prevent tax evasion by U.S. investor through offshore accounts;
• FDIP income is fixed, determinable, annual or periodical income sourced in U.S.

• Foreign Financial Institutions FFI defined as holding financial assets for the accounts of others; can enter into an agreement with U.S. authority IRS by Jan 2013 to be identified as participating PFFI; entails duty to report to U.S. authorities on any accounts held by U.S. investors
• Non-participating N-PFFIs will be subject to 30% tax withholding of all U.S.-sourced payments such as dividends/interests paid by U.S. corporates
**BaseL III**
Global Capital Rules

**Timeline**
- **G20 by end 2012: EU CRD IV; in U.S. – Dodd-Frank Act implications**
- **Insurance: EU Solvency II by 2014 – same aim as B3 re capital; investor transparency (look through); asset allocation/corporate structure implications**

**Dodd-Frank Act/Volcker Rule**
U.S. comprehensive rules reforming financial services

**Timeline**
- Signed into law in July 2010
- Dodd-Frank effective from July 2011; Volcker Rule phased from July 2012

**Key Themes**
- U.S./non-U.S. investment advisors need to register with the USSEC if AUM greater than USD100/25 million, respectively, attributable to U.S. investors
- Consequences are stricter record keeping, reporting requirements, oversight and inspection on e.g., AUM, capital leverage ratios, counterparty credit risk exposure, trading and investment positions, valuation policies, liquidity and short selling provisions, books and records retention
- **Volcker Rule** mandates the segregation of banking and proprietary trading and from sponsoring or investing in AI management functions; leading to spin-offs of proprietary trading desks, HF/PE arms by banks
- Central clearing of OTC derivatives similar to – but different and also coming into force earlier than – the European EMIR rules (G20)
- Regulatory uncertainty as many implementing rules not yet finalized

**Key Themes**
- **Deleveraging:** new global standards designed to strengthen capital and liquidity; stress testing; creating a more robust and resilient banking sector
- Systemically important financial institutions (SiFIs) to have loss-absorbing capacity beyond existing standards; “living-wills” recovery & resolution plan **RRP**
- Higher risk weightings on derivatives: 2% against initial margin posted to the CCP; clearing members to hold capital against exposure to clients
- **New capital thresholds and structure**

**EMIR**
EU Market Infrastructure Regulation

**Timeline**
- EMIR proposal published in Oct 2011; trilogue consensus reached in Feb 2012
- Industry compliance targeted for Jan 2013 (G20 commitment)
Key Themes

• Central clearing of OTC derivatives through a CCP similar to U.S. Dodd-Frank; otherwise capital charges apply; need to review risk management

• Common governance standards for CCPs and pan-EU requirements for CCP interoperability regarding equities; third-country CCPs need to meet new EU standards if used by EU counterparties

• Increased margin and collateral requirements: portability and eligibility of collateral not yet finalized, e.g., required is “highly liquid collateral”

• Operationally need to review number and type of collateral relationships with clearing brokers factoring in all risk management aspects

• Mandatory daily independent valuation and collateralization of those trades that are not cleared through a CCP centrally

• Trade repositories: mandatory registration of all derivative contracts

MiFID II
EU Markets in Financial Instruments Directive

Timeline

• MiFID II Regulation & Directive proposal published in Oct 2011

• Industry compliance targeted for July 2013 onward

Key Themes

• Widened scope in 3 aspects: 1) new instruments, 2) venues, 3) activities; captured will be e.g.: almost any type of derivatives; organized trading facilities (OTFs), “dark pools”; high-frequency algo trading activities

• Derivatives on-exchange trading (ETD): if sufficiently liquid (standardized) derivatives shall be traded on-exchange; then cleared centrally (EMIR)

• Structured UCITS classified as complex products – marketing impact: MiFID sales and transparency rules will apply; this will increase operational complexity of distribution of structured vs. nonstructured UCITS

• Advisor commissions/inducements: ban of commission payments for independent advisors from 2013 (potentially creating an unlevel playing field with insurance or other products, i.e., non-MiFID PRIPs)

• Depositary: envisaged to be classified as “investment advice” instead of just “ancillary service” under MiFID increasing compliance requirements and costs

AIFMD
EU Alternative Investment Fund Manager Directive

Timeline

• Level 1 Directive in force since July 2011; effective for industry from July 2013

• Level 2 final implementing measures expected for end 2012

Key Themes

• Applicable: to non-UCITS funds, including hedge funds, private equity

• EU domicile: applicable if the alternative fund (AIF) or manager (AIFM) or investor is domiciled in one of the EU 27 member states

• Passport: EU managers can apply for a passport from July 2013 (equivalent concept to UCITS); for non-EU managers from 2015, until then private placement

• Third-country/marketing rules: non-EU funds e.g., domiciled in Cayman, Guernsey, Jersey, Switzerland, etc., will require prior authorization in Europe

• Investment rules: on investment strategies, risk management, governance, remuneration, reporting obligations to both: regulators and investors

• Delegation: similar to UCITS/MiFID, but aims to prevent any potential approach by service providers of “outsourcing risk or liabilities”
• Depositary liability rules outlines below: a single depositary for each AIF needs to be appointed for all non-UCITS; impact on fund economics

EU PRIPs/UK RDR
EU & UK Rules for Retail Fund Distribution

Timeline
• EU PRIPs – “Special Eurobarometer 373” report published in March 2012

• UK RDR effective for industry expected from Jan 2013

Key Themes
• Definition Packaged Retail Investment Products – offer exposure to underlying financial assets but with a modified exposure compared to direct holdings; no clear-cut definition yet but aim to capture retail UCITS, insurance and structured or otherwise manufactured products

• Marketing rules/PRIPs KIID: pan-EU regulation aims to raise and harmonized standards for PRIPs distribution to better protect investors; expected incorporation into existing law, e.g., MiFID II, Solvency II/IMD II, etc., capturing 1) the form/content of disclosure document (KIID) and 2) sales process

• Aims also to establish a level playing field across various investment products and their distribution to retail market; uniform rules expected to make products more comparable; envisages KIID responsibility with manufacturer

• UK RDR Retail Distribution Review: ban of commission payments for all advisors from 2013 (going beyond MiFID proposal)

UCITS IV/V
EU Mutual Funds

Timeline
• UCITS IV in force and mostly implemented by EU 27 member states

• UCITS V proposal expected for May 2012

Key Themes
• Passport: in force for management companies

• Marketing rules/KIID: Key Investor Information Document will be further standardized + have more information on risk, calculation methodology, charges

• Master-feeder structures: a more harmonized approach across Europe may stimulate growth in cross-border pooling and mergers, but tax issues remain

• “NEWCITS”: HF managers offering more UCITS products since the possible inclusion of derivatives tapping into new investor segments & target markets

• Depositary: new liability rules as in AIFMD expected to spill over into UCITS V whereby depositaries are

- liable for the loss of financial instruments held in custody

- have the obligation to return corresponding amount without undue delay

- following that may prove – cumulative – that the loss is a result of

  1) an external event,

  2) beyond its reasonable control,

  3) the consequence was unavoidable,

  4) despite efforts to the contrary