EMEA

Performance

A triannual topical digest for investment management professionals, issue 13, January 2014

In focus

Deloitte.

In this issue

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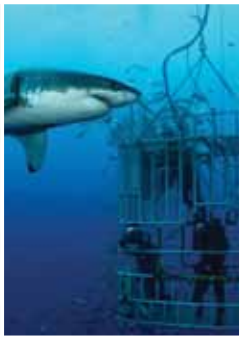

Foreword

Dear readers and friends,

First of all, we would like to wish you and your families a Happy New Year! 2013 was a challenging year for our Investment Management industry and we expect this New Year will call for the same level of attention from all of us.

It is with particular pleasure that we present this current issue of Perform*ance*, our leading edge publication where we bring together views, analysis and thought leadership. It is not by chance that this edition coincides with the World Economic Forum, nor a coincidence that within the articles we present here for your perusal and reflexion you will find the themes that form part of the debate at the Forum, and the challenges that make such a Forum essential to the positive evolution of financial markets and institutions.

The objectives of the Forum, and our objectives in reaching out to you with these articles, are very closely aligned. We are living in a period of unprecedented change in the financial world, with innovation and global trends interacting with imperatives that are much closer to home. Cost management and optimisation are as important as wrestling with regulatory change; understanding the dynamics of a changing market place is impossible without understanding the potential of new technologies, of social media and of changing cultural and demographic trends. Decisions taken in any or each of these domains will inevitably impact the lives of our clients, and shape the destiny of generations to come.

In this issue, which is a further step along the path of enriching our own expertise with articles jointly authored by recognised and known market figures to capture their insightful experience and points of view, we examine regulatory change in several key areas. We look at Governance issues and delve into the technical realms of pricing, and in an environment in which a degree of 'normality' if there is such a thing, is returning after the financial crisis we examine developments in the M&A market. Thankfully, we may not talk of death, but we certainly speak of tax! In short, something innovative, something thought provoking and we trust something of interest to you all.

We often hear that we are 'at a crossroads' — either politically, or economically, socially or in whatever context it may be. The image has become so familiar that we rarely think beyond the immediate resonance that it conjures up. And yet a 'cross roads' describes much more than where we stand today, and the choices that are before us. A cross-roads, be it in trade, or geographically or even psychologically, arises when there is an obstacle to be overcome. It may be a path through the mountains that bar the way; it may be the place where trade routes converge, it may be that moment of enlightenment that turns concept into innovation. Whatever it is, a cross roads is where endeavour, and expertise, where initiative and ambition, encounter and overcome impediments to lead to other and brighter opportunities. That is our ambition, both for Perform*ance* and for you, and we offer it as our contribution to your way forward as you negotiate the way ahead.

Happy and prosperous reading!

Vincent Gouverneur
EMEA Investment
Management Leader

Nick Sandall
EMEA Co-Leader
Financial Services Industry

Francisco Celma
EMEA Co-Leader
Financial Services Industry

Perform*ance* is a triannual magazine that gathers our most important or 'hot topic' articles. The various articles will reflect Deloitte's multidisciplinary approach and combine advisory and consulting, audit, and tax expertise in analysing the latest developments in the industry. Each article will also provide an external expert's or our own perspective on the different challenges and opportunities being faced by the investment management community. As such, the distribution of Performance will be broad and we hope to provide insightful and interesting information to all actors and players of the asset servicing and investment management value chains.

Editorial

Dear readers of Perform*ance*,

We would like to welcome you to the 13th edition of Deloitte's global magazine for the investment management sector. Much has changed since the first edition of Perform*ance* in the aftermath of the financial crisis. The global economy is slowly picking up again and most developed economies are growing. While the investment management industry has been able to enjoy progress, many challenges still lie ahead. Regulation is constantly evolving and the cost of being compliant, especially at a global level, has never been greater. At the same time, investors have become increasingly demanding and started taking greater interest in performance and transparency. This more involved approach to investing is putting significant pressure on margins.

In this new environment for asset managers, we would like to give our readers some thought-provoking insights. As such, we have broadened the involvement of our external contributors to further expand our industry knowledge-sharing platform. Furthermore, each edition to follow will be led by a different Deloitte IM practice and have a focus topic that a number of articles will cover.

In this edition of Perform*ance*, which contains valuable contributions from a range of industry experts, we focus on the future approaches to wealth management in Europe, and especially in Switzerland, in light of European tax and regulatory changes. We also examine some of the regulations impacting (or soon to be) the investment management industry in Switzerland and the EU. For example, we outline the impact of MiFID II and take a look at the debate on shadow banking regulation. A significant contribution to the overall theme will also be made by our external contributors, who will give their views on Switzerland's future as a wealth management centre.

In addition to our main theme, you will find the usual variety of topics ranging from new tax regulations for the distribution of funds to the results of Deloitte's global risk management survey and the implications for investment managers. We also look ahead to the mutual funds markets in 2014.

We wish you all a successful start to the New Year and hope you enjoy reading this edition of Perform*ance*.

With our best wishes,

Simon Ramos
Editorialist

Andreas Timpert
Switzerland Investment Management Leader

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In focus

David Blumer - BlackRock

David J. Blumer, Senior Managing Director, is head of EMEA for BlackRock and is a member of both the Global Executive Committee and the Global Operating Committee. Prior, Mr. Blumer was Chief Investment Officer and a member of the Executive Committee at Swiss Reinsurance as well as Chief Executive Officer and a member of the Executive Board at Credit Suisse's Asset Management.

Martin Bidermann - Rahn & Bodmer Zürich

Martin Bidermann has been partner at Rahn & Bodmer Zürich since 1990 and has had responsibility for the Customer Advisory Services since 2001. Prior, Mr. Bidermann has obtained a vocational qualification in business studies and spent his further training in North America and Japan, gaining in-depth knowledge of international securities trading.

Thomas Kubr - Capital Dynamics

Thomas Kubr served as founding CEO of Capital Dynamics for over 12 years, before taking up his current role as Executive Chair of the Board of Directors. He leads the firm's client development activities and overall strategic development, as well as its investment strategy as a member of the Investment Committee. Prior, Mr. Kubr was Head of Private Equity at Partners Group and a consultant at McKinsey & Company.

François Rayroux - Lenz & Staehelin

François Rayroux is co-head of the Banking and Finance group at Lenz & Staehelin where he leads the Investment Management practice. He is considered by various professional organisations the leading expert in banking and financial as well as capital market law in Switzerland. He has a Masters degree (lic. iur. 1986) and a Ph D (Dr. iur. 1993) from the Zurich University.

Petra Reinhard - Credit Suisse

Petra Reinhard, Managing Director, is the Head Fund Solutions & Client Services at Credit Suisse. Prior, Ms. Reinhard worked as Head Private Label Funds & Fund Projects at Julius Bär. She is an alumnus of the Stanford Executive Program, after having originally completed her studies in law at the University of Basel with a focus on national and international tax law. Since 2010, she represents Credit Suisse in the Board of Directors of the Swiss Funds and Asset Management Association SFAMA.

The future of asset management in Switzerland

At the time of writing this article, a second Swiss bank had just decided to give up its business in the wake of the U.S. tax investigation. We are not talking about banks with entities and operations in the U.S.; both banks are Swiss-domiciled without any offices or representatives in the U.S. Neither bank is in breach of any Swiss laws and no infringement of the laws of any other country has been established in a court of law.

The financial crisis sent shockwaves around the globe, with the collapse of Lehman Brothers, the bailouts and in some cases the nationalisation of major financial institutions such as UBS, RBS and AIG. It has considerably changed the way investors look at the risk of default of major 'blue-chip' corporations.

As the world, and particularly Europe, tumbled into a recession, unemployment and welfare spending have further increased the strain on national budgets. As the U.S. is moving slowly towards recovery, in addition to the above, it has had to deal with a political stalemate.

The historically low interest rates, as a result of the sustained period of expansive monetary policy, combined with the demographic trend of longevity are both an immense challenge as well as a major opportunity for those who can read the signs of the times.

As a wealth and asset management centre located in the middle of Europe, Switzerland is very much affected by all these developments. But what does the future hold for Switzerland? What challenges and opportunities will the country face as it seeks to maintain its leading position, and how should the Swiss asset management industry prepare for the future?

We have interviewed five experienced representatives of the Swiss asset management industry who offer different perspectives from their various professional backgrounds.

Interview by Marcel Meyer, Partner Deloitte

Q: *What makes Switzerland an attractive location for asset management compared to other major wealth and asset management centres?*

David Blumer
Switzerland has been a very attractive location for wealth management operations for quite some time, both in the asset management area and within the private banking sector. Private banking has traditionally been the more important pillar, with the international environment, the highly-qualified talent pool, the stability as well as the longstanding tradition and experience in this market being the key factors contributing to this success.

Martin Bidermann
We are clearly going through the biggest change of paradigm since the introduction of banking secrecy in 1933. A key factir is the increasing penetration of IT. Data is available everywhere, it can be very quickly copied and transmitted, and it is expensive to keep control over. Since 2008 everybody seems pre-occupied with the regularisation of the past and it currently looks like this process will not be completed before the end of 2014. New money will be flowing into Switzerland, not because of tax advantages or because of Swiss banking secrecy, but because of the traditional 'Swissness': trust, reliability, stability, education and experience.

Thomas Kubr
Switzerland's success and reputation as a financial centre is built on trust, strong personal relationships and high-quality service. As a small country in the heart of Europe looking back on hundreds of years of democracy, continuous government and a stable currency, I cannot think of another country that comes even close to possessing that foundation of trust. Switzerland can capitalise on its strengths by positioning itself as the country for long-term stability, where the money investors have here can be protected in the best possible way. I find it very sad that the country is often viewed through the lens of numbered accounts because that part of the banking business has never been a significant contributor to the Swiss economy.

David Blumer
Developments over the last few years surrounding tax disclosures and information exchange have, to some extent, resulted in a shift of focus away from private banking and an increased focus on asset management. We see this as a positive development and a trend that is in line with our investments in the Swiss market. BlackRock has acquired the private equity fund of funds business from SwissRe and the ETF business of Credit Suisse, and is in the process of creating a fund management company in Switzerland. As the regulatory environment changes, it becomes more and more critical to be operationally present in a market, as it is no longer possible to be active in a jurisdiction from a distance.

All these developments have been factored into our strategy and will support the growth of our business in Switzerland.

> Switzerland can capitalise on its strengths by positioning itself as the country for long-term stability, where the money investors have here can be protected in the best possible way
>
> *Thomas Kubr*

François Rayroux
When in 2009 it became clear what shape the AIFMD would take, I immediately realised that this was going to have a profound impact on the Swiss asset management industry. It was clear that some activities, distribution as the most prominent example, would have to move abroad as they could not be performed in Switzerland anymore. I understood that cross-border solutions would disappear; as one needs to be where distribution happens. Back then, it looked like Switzerland would be completely locked out of the common market in Europe.

Q: ***How do you see the competitive landscape and the major local and international trends at the moment and how do you see them evolving over the next decade?***

David Blumer
A key factor is the regulatory environment. It has changed considerably in recent years and will continue to do so. Among other factors, this has contributed to increased uncertainty for market participants. Requirements in the area of compliance and risk management are continuously increasing and all firms will incur additional costs, which will increase competition even further. As a result, it will be necessary to have a certain critical mass in order to be successful. The alternative strategy is to focus on a niche and be a specialist for particular investment themes. Regulation has, and will continue to drive this development, and players lacking critical mass or specialisation will struggle in the future.

Another key development is the trend towards passive investment strategies, which is changing the asset management landscape. We are currently seeing significant growth in passive strategies. The question is how to position yourself in this market segment, because with passive strategies there is little scope for distinction. BlackRock follows an approach whereby we offer both active and passive strategies. We see them as complementary and we believe there is a lot of value in this approach.

> New money will be flowing into Switzerland, not because of tax advantages or because of Swiss banking secrecy, but because of the traditional 'Swissness': trust, reliability, stability, education and experience
>
> *Martin Bidermann*

Petra Reinhard
The uncertainties caused by globalisation, changing client behaviour and increased regulatory pressure, are seen as the major threats to the asset management industry in Switzerland. However, uncertainty can become a prime source of future profitability for those who read the signs well and position themselves accordingly. Market players will need to develop their value propositions and align their business models based on the right strategic initiatives. The successful asset manager has to define his initiatives as a result of careful analysis: what do we do in our clients' best interest, who do we want to serve with what kind of products and services and where and how can we ensure sustainability?

A convincing value proposition will be key for market players to deliver measurable added value for clients and achieve sustainable growth.

David Blumer
Independence is also becoming a key topic. There is a trend towards resolving the conflicts of interest that are still present in the investment value chain. Clients are increasingly selecting providers that pursue a distinct fiduciary approach.

Q: *What are the key success factors when developing a new product or deciding to enter a particular segment of the market or asset class?*

David Blumer

We address issues that are currently not yet on everybody's radar. If we think it is a crucial topic to think and talk about, then we directly and openly address it, even if it is not at the top of the agenda. One of these topics, for example, is longevity and the ageing of the population. Everybody knows that this will be a huge issue, but for many it is not yet something to be addressed. We think it should be discussed, even if the exact impact and the solution to the problem are not yet fully known. It is important that a common understanding is created. We will all be living much longer, interest rates are currently very low, and so we need to get a common understanding of what this means for our retirement.

Interest rates are another example. For now they are low, but at some point they will increase again. The implications of this should be discussed, and scenarios should be worked out to understand what the potential consequences are and what can be done to prepare investors. We are currently engaging in these discussions with asset and wealth managers. It is crucial that these things are discussed now, because the world of investing will change, and the pace of change will increase.

Martin Bidermann

As the oldest private bank in Zurich, with the majority of our clients coming from the region, we are convinced that our future lies mainly in Switzerland. We understand the Swiss market and have the know-how to operate in Switzerland. The three families (Rahn, Bodmer and Bidermann) are represented by five members in total.

In some instances we service as many as four generations of a client's family. The region of Zurich is not too small for us and we see many opportunities here.

As entrepreneurs we are not thinking from quarter to quarter—we are thinking from generation to generation. Our objective is to hand over the bank to the next generation in a good state—just as we took it over from our fathers in the early nineties.

Petra Reinhard

The asset management industry is directly and indirectly affected by macroeconomic developments. As a result of these, as well as other external factors such as regulation and government intervention, asset managers need to review and adapt their business model in order to remain competitive. As in many other industries, the power base within the value chain has shifted toward demand.

The successful asset manager has to define his initiatives as a result of careful analysis: what do we do in our clients' best interest, who do we want to serve with what kind of products and services and where and how can we ensure sustainability?

Petra Reinhard

Q: *What strategy do you pursue in order to remain competitive in such an environment and what are the opportunities you see for your company and for the asset management industry in general?*

David Blumer
Two key questions are crucial in today's environment: What are the needs of the clients and how are these needs changing over time? This is the basis for our analysis. It is certainly not an easy analysis in the current environment as there are so many factors to consider and they are all interconnected.

Petra Reinhard
Asset management today is a global activity and therefore, a competition between financial centres is inevitable. Switzerland is one of the most successful business locations, but all stakeholders need to ensure that it remains a competitive place in financial services and to put forward ideas that will help the country to develop into a globally recognised centre for asset management. The 'Swiss Funds & Asset Management Association' togheter with the Swiss Banking Association intend to position Switzerland as an important base of operation for the asset management industry.

This SFAMA/SBA initiative has the objective of developing Switzerland into a leading location for asset management.

It is a chance to improve existing frameworks and define new conditions for asset management to give existing Swiss-based asset managers the opportunity to position themselves better and to offer a favourable environment for innovation, which also means establishing excellent connections with research and academic networks, and creating a favourable investment environment for 'angel' investors.

We should use the momentum of the initiative to give greater diversification to the financial business and enhance Switzerland as a place to do asset management business.

David Blumer
For Switzerland, it will be crucial to remain competitive and to continue to invest in the existing and future talent pool through education, and to ensure that skills and experienced managers do not leave the country. The asset management initiative of the Swiss Banking Association, in cooperation with the Swiss Funds and Asset Management Association, is a key element to achieving this objective. Other financial centres are working on building their reputation and developing long-standing client relationships, while we in Switzerland already have this; but we need to make sure that we don't lose this asset.

> One of these topics, for example, is longevity and the ageing of the population. Everybody knows that this will be a huge issue, but for many it is not yet something to be addressed
>
> *David Blumer*

Thomas Kubr

As an experienced Swiss manager investing in private markets globally we see a lot of opportunities for our clients. There is an illiquidity premium generated by private investments and many reasons, such as preservation of wealth, support an increased allocation to this asset class, provided investment timeframes and liquidity requirements are managed properly. In my view, given the needs of a long-term healthy retirement system, pension funds and life insurance companies really cannot afford not to take advantage of the significant outperformance private investments can generate.

David Blumer

Our approach is to remain flexible and to maintain a very broad and deep product range. In this way, we are able to offer products suitable for a wide range of client profiles. And, even more importantly, we are able to offer comprehensive solutions to our clients.

That is the core of our strategy. We want to offer solutions, rather than just products. Solutions are more complete and incorporate areas such as risk management. Comprehensive solutions create closer long-term ties with clients, and this is the most important asset for any business.

Asset management today is a global activity and therefore, a competition between financial centres is inevitable

Petra Reinhard

Q: *Speaking of regulation, what is your view on the Swiss regulatory environment as compared to the other core markets you are competing in?*

David Blumer

The general direction is very similar, be it in Switzerland or the EU, including the United Kingdom. At the same time, there are clearly certain local specific requirements and, of course, Switzerland has its own 'Swiss finish'. But this is the case for most countries and there are often different interpretations for any particular general rule. Admittedly, this doesn't make doing business easier, but it is an environment which is clearly continuing to develop. One has to see this as an opportunity to contribute to the discussions and the reforms.

Thomas Kubr

Regulation has a very important role to play: it provides transparency and fraud prevention. However, in Switzerland I see a divergence in a sense that on one hand the regulator is not tough enough in enforcing existing laws in areas like insider trading. On the other hand, Swiss regulation now tends to overprotect sophisticated investors: i.e. forcing them to comply with the same rules as retail investors isn't helping sophisticated investors. For me, regulation is key to providing transparency and a level playing field for competition, and keeping the markets free from fraud, but it should not penalise qualified investors.

François Rayroux

One of the key strengths of the country is the long tradition of conceptual law. Swiss law is mostly principle based, and not process driven and derived from specific cases as in the common law tradition of the Anglo-Saxon countries. Financial markets and products have become so complex and innovative that it will never be possible to create a process-based codification for every specific case covering all possibilities and eventualities. Instead, it is important that the main rules and principles are defined and that there is a clear line of interpretation. There is pressure on our legal tradition as it needs to be accepted as equivalent. However, I strongly believe that principle-based regulation is more effective regulation, and we need to continue to explain this to our partners.

Martin Bidermann

We are regulated by the Swiss Regulator FINMA. We have personal and unlimited liability for all unpaid debts of the bank. This is a very effective way to regulate our business. If every company was organised like this the banking industry would need much less regulation.

François Rayroux

Today, Swiss regulation is seen as mostly equivalent, and the sovereign debt crisis has somewhat counterbalanced the isolating effects of European regulation by presenting Switzerland as an attractive and stable domicile in the heart of Europe. However, as a non-member of the EU, Switzerland's ambition can only be the first place among all the third-party states. This is the joker we have to play.

One of the key strengths of the country is the long tradition of conceptual law. Swiss law is mostly principle based, and not process driven and derived from specific cases as in the common law tradition of the Anglo-Saxon countries

François Rayroux

Regulation is changing the distribution landscape

Christophe Girondel
Head of Distribution
Member of Executive Management
Nordea Asset Management

The distribution of asset management products in Europe has been at the centre of debate since the launch of the Single European Act. Besides ensuring a common framework for financial products across Europe, the concept of sound advice on asset management products has been, and is, a core concern. The key question is: how can regulators ensure that clients receive quality advice when taking investment decisions?

Recent regulatory developments relating to asset management products, in particular the notion of advice, are further aimed at changing the European distribution landscape for the benefit of the consumer; but seem to be accompanied by some far-reaching unintended consequences.

Regulation for the better

Before analysing current and upcoming changes, it is worth reflecting on the key developments that have occurred since the freedom of services act was applied to financial services (insurance, banks and mutual funds) in the European Union.

At the outset, the European Union chose to regulate products rather than distribution itself, as the landscape was deemed too diverse to find real convergence. As an illustration, the distribution of financial products in the United Kingdom has always relied on traditional independent financial advisors, while banks and mortgage institutions have played a very limited role; this is very similar to the United States model inherited from the Glass-Steagall Act[1].

On the other side of the spectrum, banks have always played a central role in continental Europe. In France, for example, consumers traditionally seek advice from their banks when saving. Such practice is common across continental Europe, even if it varies across countries, e.g. in Sweden the insurance sector has historically played a much larger role. As a consequence, the European Union did not regulate the distribution model but instead focused on products, leaving the oversight of distribution to local regulators and governments. What altered the European landscape was the impact of the UCITS product directive, which proved to be an important catalyst in changing the distribution of asset management products. Indeed, with the exception of the UK where the importance of the independent financial advisor community allowed open architecture and supported multiple asset management boutiques, the rest of Europe was characterised by the distribution of in-house products manufactured within internal asset management units.

The UCITS product directive was fundamental as it created, for the first time, a single framework for a European product and opened the door to cross-border distribution. Suddenly, distribution to 350 million citizens became possible, creating potential economies of scale for non-bank owned asset managers whether of European, U.S. or any other origin. Although banks or insurance companies remained reluctant to propose such external solutions, the existence of financial advisory networks in Germany and Italy, and later in France and Belgium, allowed competition to flourish. Eventually this pressure became so strong that banks had to start offering third-party products, increasing the quality of the solutions offered to consumers and improving the impartiality of their advice.

It was in the middle of this wave of open architecture that the triad (Council, Commission, and Parliament) decided to expand their policies and build a common framework for advice. The MiFID directive introduced new regulations, notably covering advice across Europe. The measures encompassed establishing a risk profile for each investor, rating products according to their level of complexity and risks, developing a suitability test approach and defining key transparency requirements on products and incentives. The directive applies to all players, whether banks or investment firms, with the noticeable exception of the insurance sector.

Regulators were clearly aiming to unify advice practices across Europe. The result was greater competence of financial advisors and improved protection of retail investors by setting some important new standards. It encouraged independent advisors to join forces to create larger investment firms capable of challenging the major banking institutions.

1 The Glass-Steagall Act separated commercial banking and investment banking. As a result, the distribution of mutual funds and securities came to be performed by independent brokers. The strict separation was lifted under the Clinton administration.

As a consequence, the landscape today is quite different from that at the time the freedom of services act was established, but it has been a slow evolutionary process:

- The Nordic and German banks as well as insurance companies are still leading distributors. However, the IFA and wealth management sectors have developed strongly. This is largely thanks to consolidation, which was necessary to accommodate the growing burden of compliance and regulatory costs
- The French market retains a bank distribution model, where concentration has reduced the number of players to five large institutions. Despite this, the financial advisor community has been growing. One positive consequence is the support that has been provided to the creation of boutique asset managers, which did not exist a decade ago
- Southern Europe has experienced a shift in distribution from the traditional banks to networks of financial advisors. This is largely due to the recent crisis, and has favoured foreign asset managers providing non-domestic products
- The United Kingdom has only been minimally affected by European regulation; the launch of the Retail Distribution Review (RDR) has had a greater impact

Without a doubt, regulatory development has favoured further competition and fostered the development of better advice for the end consumer. This is despite the fact that distributors continue to receive commissions from the product manufacturer for their activities, a business model similar to insurance distribution.

> At the outset, the European Union chose to regulate products rather than distribution itself, as the landscape was deemed too diverse to find real convergence

To all intent and purposes it is almost impossible to perform the necessary impact analysis, thus increasing the risk of unintended consequences

More regulation—for the better?

With the financial crisis bringing the global economy to the verge of collapse, European governments took charge of the necessary strengthening of the financial regulatory framework. It almost goes without saying that excesses needed to be addressed with structural reforms.

The Commission has undertaken many different initiatives, including the European supervision framework (EBA, ESMA, etc.), MiFID review, EMIR, CRD III and IV, AIFMD, UCITS V and ECB banking supervision. Not all of these measures have been ratified, let alone implemented, but it is undeniable that major structural reforms have been or are being introduced. It is also noticeable that the asset management industry and in particular its mutual fund business, already subject to one of the most stringent regulatory regimes in Europe[2], has been further subject to increased scrutiny.

When so many new regulations come into force, the risk of implementing overlapping and contradictory rules cannot be ignored. To all intent and purposes it is almost impossible to perform the necessary impact analysis, thus increasing the risk of unintended consequences. Some of the measures will alter the European distribution landscape for financial products, and in addition, individual countries have launched local initiatives, making the regulatory environment even more complex.

In particular, the distribution of mutual funds, and its related incentives structure, has been the target of the FSA in the UK, with the RDR, or the AFM in the Netherlands, with the imminent ban on retrocessions.

When it comes to the financial crisis and the regulation of asset management products in particular, the initial reaction of distributors has been to become extremely risk averse. The first indication is that large banks have been focused on counterparty risk, not within asset management products but in relation to promoters. As a consequence, financial institutions have stopped working with asset management boutiques, instead favouring relationships with large players demonstrating a solid financial base. The aim is to limit the reputational risk and costs associated with the selection of asset management products, by privileging large brands. As a result, some of the more innovative asset management boutiques have had to cope with a lower asset base meanwhile absorbing the costs associated with new regulations. The result is that they are therefore either withdrawing from the market or merging with other firms. On the other hand, banks have prioritised their discretionary business to minimise risks related to advice. This has taken the form of awarding significant assets to well-known asset management brands, leading to very large funds becoming even bigger. Their sheer size and liquidity then becomes a source of potential market risk. There can be no doubt that the barriers to entry have been raised dramatically in the industry. As an unintended consequence, end clients have less choice and could lose out on quality and innovation. Worse still, the potential for market risk/volatility could be set to increase.

Within the wave of regulation, governing bodies have started to put into question the remuneration model for distribution across Europe. A new model has become effective in the United Kingdom and will be introduced in the Netherlands at the beginning of 2014. The rebate discussion has moved on at a European level and now concerns only mutual funds. It is unclear if PRIPs[3] will apply to other financial products, and it seems certain that the insurance sector will not be included (i.e. the insurance sectors will continue to pursue their bundled business model).

2 *To illustrate, the distribution of UCITS is almost subject to dual regulation: the UCITS directives, when it comes to the product, its management company and its passporting rules; but also to some extent MiFID in relation to its distribution (financial institution or investment firm).*

3 *PRIPs: Packaged Retail Investment Products*

While the aim of unbundling pricing for distribution is very welcome as it leads to greater transparency, it has far-reaching side effects:

- For the mutual fund industry it would create an uneven playing field with insurance or structured products; moreover it is difficult to see the justification for the difference in treatment between competing savings products
- It has now become apparent that prices are actually increasing in the United Kingdom rather than decreasing after the first year of the implementation of RDR, as all parties in the value chain are reassessing their fee models and costs
- It leads to the creation of an advisory fee, which might push advisors to churn client portfolios simply to prove that they are pursuing active advice, i.e. core investments run the risk of appearing to be 'lazy asset allocation solutions'
- It might also strengthen the relative position of the banking sector, which benefits from a holistic relationship with clients, where charging for advice is only one component. For independent financial advisors or wealth managers, it is the only source of revenue and their ability to charge such a direct fee is not yet established. This situation might have important consequences:
    - Retail consumers may choose to no longer receive advice and become self-directed investors; experience tells us this leads to asset misallocation
    - Independent wealth managers, still at the infancy stage in continental Europe, could end up withdrawing from the market, which would further strengthen the power of banks
    - Without a healthy independent wealth management sector, asset management boutiques will not survive. It would be impossible for these players to source their first assets from the banks who favour established brands, three-year track records and funds with large volumes of assets under management

Better for the consumer?

The regulatory agenda is fundamentally changing the distribution landscape in Europe, but this is not a new phenomenon. It is worth remembering that the freedom of services act is at the source of the cross-border asset management industry in Europe. It has allowed the creation of a single market and opened up alternative solutions to the self-manufactured products of banks. The MiFID directive further enhanced the framework with requirements for sound advice when it comes to financial products. The main caveat is that it unfortunately did not encompass the insurance sector.

Post-crisis developments have led to several regulatory initiatives to address excesses in the financial sector. Any financial professional should welcome such action. However, some of the initiatives may lead to unintended consequences when it comes to the distribution of asset management products. The risks are quite significant: privileging remunerative insurance products over investment funds, the disappearance of small asset management boutiques, the concentration of distribution in the hands of large banking institutions, the reduction of choice for consumers, the resurgence of sub-standard self-manufactured products and potentially rising costs for end investors. It is crucial that these risks are mitigated, as some of them may outweigh the benefits of new regulation and could lead to a world where the quality of advice is not improved.

Regulators, and the financial industry itself, must not lose sight of the end client. It is critical that reform is not rushed but considered, to ensure end investors benefit from choice, transparency and simplicity; e.g. alternative measures could require distributors to propose to clients to choose between the bundled and the unbundled pricing approach, thereby empowering end consumers.

Finally, regulation is only one of a number of possible levers available: stakeholders could focus more on education as a way of empowering end consumers to help them make more informed decisions. It is remarkable that children are taught physics and literature but very few European school curricula integrate financial literacy into their syllabus. This is not only true for savings, but also for lending products. Consumers are all too often confronted with making difficult decisions that will have a direct impact on their lifestyle and retirement, without having the necessary education. Financial literacy should start at school, but it is also the duty of the financial and asset management industry to become more active. Sometimes it is down to small innovative entrepreneurs to set a good example. In Spain, independent financial adviser Maria Jesus Soto has written an educational book[4] on investing, with children in mind. The rest of the industry should follow suit, and embrace the challenge that lies ahead.

4 Mi primer libro de economia, ahorro e inversion

To the **point**:

- Historically, the European regulatory framework (UCITS and MiFID) has favoured further product competition and fostered the development of better advice for the end consumer
- Recent regulatory developments are however numerous and complex, making it almost impossible to perform thorough impact analysis, thereby increasing the risk of unintended consequences
- Unbundling mutual fund pricing structures to increase transparency, but not doing the same for alternative saving solutions increases the risk of regulatory arbitrage to the detriment of mutual funds
- The resulting fee-based advice might favour banks at the expense of wealth managers and independent financial advisors, which could result in concentration of distribution and lead to less competition, lower quality products, reduced choice and rising costs
- Mitigating these risks goes hand in hand with empowering end consumers in their ability to make informed decisions

Europe's M&A recovery: a long-awaited chance for investors

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European M&A activity has been lagging since the financial crisis began. But now, all conditions are met for buyers and sellers to engage in high-value spin-offs, restructurings or bids that even the prospect of weak economic growth will not deter.

The financial turmoil of recent years has created numerous victims, including Europe's M&A market. For six years, M&A activity in Europe was on a downward slope, falling both in terms of value (-54%) and number of deals (-22%). This trend might have continued during the summer, when deal-making is usually dormant. Against expectations, however, a number of deals hit the headlines: Schneider/Invensys, Publicis/Omnicom, Vodafone/Verizon, Microsoft/Nokia and Vivendi, clear evidence that European M&A is indeed starting a new opportunity-rich cycle.

For European M&A to recover, certain conditions had to be met. The first condition, and the main reason why the upturn took so long to come, was investor confidence. In recent months, Europe, and particularly the eurozone, seems to have finally emerged from recession. The best example is Spain, which saw exports surge and competitiveness increase. Meanwhile, the relatively sound macroeconomic environment in the United States is good news for its biggest trading partner over in Europe.

As a result, confidence is returning and momentum is upbeat. Encouraged by much rosier prospects, companies are finally acting, often over plans that have been in the pipeline for some time.

In fact, opportunities and financial clout were never issues to begin with. First, the European market has been crowded with opportunities since the crisis depressed valuations all across Europe. In terms of asset prices, the EuroStoxx 50 is now 32% cheaper than the MSCI World Index and is trading on a price/earnings ratio of 13.6 compared to 15.8 for the Standard & Poor's 500 Index. These valuations are particularly attractive to hungry buyers across the globe.

Second, companies are cash rich. They need to use this cash strategically and on value-added projects, as shareholders are increasingly asking for dormant cash to be returned to them. Furthermore, companies have put so much effort into deleveraging that they prefer to use cash reserves instead of depending on bank loans to fund deals. In addition, undervalued stocks mean buyers are reluctant to use equity to finance acquisitions.

As a result, the proportion of cash deals rose from 59% of global M&A transactions in 2009 to 70% in 2011. However, aspiring buyers with smaller cash piles can still join in, as with interest rates generally at record lows they can turn to banks for funding. All in all, M&A activity looks set to increase in Europe, at cheap prices and with attractive strategic and revenue growth. However, there are factors that could hamper the progress of this new M&A cycle. We have identified two main factors, but we do not believe they are significant enough to diminish the M&A investment opportunities that will offer value to investors.

The relatively sound macroeconomic environment in the United States is good news for its biggest trading partner over in Europe

First, the backdrop of weak economic growth, rocketing sovereign debt and persistent public deficits might threaten M&A strategies in Europe, particularly if companies expect higher taxes or more protective laws to compensate for government deficits. However, the old continent boasts intrinsic assets that make acquisitions attractive compared to other regions. It offers a stable regulatory framework, high quality infrastructure, a skilled and highly educated workforce and global brands. Europe is very attractive for companies wanting to secure deals and be protected by intellectual property and patent laws.

After waiting so long for the European M&A cycle to recover, companies with big cash piles now have the opportunity to go for non-organic growth at low valuations

Second, low valuations might put off sellers. Companies may want to sit and wait instead of letting their assets go at an unreasonably discounted price. But while it is true that some deals may be postponed for this reason, small and medium-sized companies are more likely to sell their assets, even at a cheap price, due to stronger pressure on their financial structure. Companies are adapting their growth strategies to the current environment. This new M&A cycle should therefore mark a change both in deal type and volume.

M&A deals are being broken down into smaller and smaller deals, such as non-core business restructuring and spin-offs, rather than wholesale takeover bids. The Verizon/Vodafone buyout is a good example. Because of the crisis, companies have become increasingly cautious over bids and are now paying more attention to execution risk, social risks and anti-trust laws. They prefer transactions requiring little or no cash, and which avoid massive leveraging. Shareholders have become increasingly vocal on how a company is managed and strategic growth choices have to appear legitimate. For example, the plan to spin off SFR from Vivendi met with a warm welcome from shareholders because they expect the deal to unlock significant value. Creating two large entities with clearly separated businesses and stock market listings will help shrink Vivendi's conglomerate discount and should also mean a big cash return to shareholders. The deal could also significantly rerate SFR in a telecoms sector facing intense concentration. In addition, shareholders expect Vincent Bolloré's arrival to have a positive impact on corporate governance.

Restructuring is sometimes the key to increased market value and operational efficiency. In just one year, Dutch bank ING's market value has increased by 30%. The bank had to restructure its activities because of the government bailout. Its spin-off programme is well ahead of schedule, and its insurance subsidiary is scheduled for a U.S. listing this year. Next year will see the IPO of its European insurance branch, a move that should trigger further market inflows.

Though selling or spinning off businesses is increasing popular, potential bid targets are still a major source of value for investors. Shire, the UK's third largest biopharmaceutical company, is specialised in rare diseases, neuroscience and regenerative medicine. Its R&D investments should translate into high sales potential. With a market cap of £14 billion, Shire is an appealing target for big pharmaceutical firms like Bristol Myers or Pfizer in search of growth drivers.

There is no shortage of opportunities; the key for investors is selection. After waiting so long for the European M&A cycle to recover, companies with big cash piles now have the opportunity to go for non-organic growth at low valuations. Transformational megamergers and bids are likely to decrease in volume, but we can expect to see an increase in smaller deals. Judicious stock selection should offer investors significant upside that should exceed catch-up value.

To the point

- All conditions are met for a buoyant M&A cycle in Europe: a revival in investor confidence, low interest rates, big cash piles, low valuations and the strategic need for non-organic growth
- The main factors that could delay the M&A recovery are European government austerity policies (with low economic growth and high taxes) and low valuations
- With companies adapting to their new environment, the M&A deal structure will be modified with smaller deals, more spin-offs and fewer takeover bids
- At such low valuations, M&A target companies have significant upside

This time it's different

Reshaping the way we look at risk

Laurent Seyer
Global Head of Multi-Asset Client Solutions and Distribution
AXA IM

Risk selection is the backbone of any search for growth in the context of long-term de-risking. By hedging some of the embedded risks, investors can free up space to invest in return engines

De-risking—a long term structural shift

The past year has seen growing signs of economic recovery and optimism, with a consequent rally in global equity markets and rise in bond yields. Such market moves have helped to improve the solvency of pension funds and most insurance companies; higher equity prices boost assets, while higher bond yields reduce the present value of liabilities.

This has raised questions about whether de-risking will come to an end, and whether the 'great rotation' will take hold.

Institutions are benefiting from some tailwinds, with economic growth assets firmer and signs that the euro crisis may be behind us. In addition, the Fed has hinted that it may delay tapering quantitative easing (QE) until March 2014, which may also delay interest rate rises, thus further benefiting risk assets.

While base rates remain anchored at historical lows, government bond yields have risen, easing pressure on the liabilities side of the balance sheet. But, despite the above-mentioned tailwinds, there has, so far, been little evidence of any significant re-risking as investors also grapple with structural headwinds:

1. **Financial and economic uncertainty remains:** Since the start of the crisis, macro and political factors have played a huge role in setting market directions (risk-on/risk-off trade), with a focus on short-term events translating into higher volatility.

   While QE and liquidity injections have suppressed equity market volatility over more recent years, this trend is expected to 'revert' in a post-QE world. On the other side of the equation, the injection of so much liquidity into the market has suppressed bond yields with the result that 20-year euro swap rates touched historical lows in May 2012.

It is thought that interest rates have structurally bottomed out. But there is considerable uncertainty as to whether they will remain low for much longer or whether official rate rises will come sooner than expected.

While there have been signs of improvement, a sustained recovery is not assured, and nor is the direction or timing of policy decisions. On top of this, global markets are more interconnected than ever before, with any policy decisions on one side of the world driving markets on the other, as we have seen with the impact of the mere talk of the Fed tapering across the globe.

On both sides of the risk-on/risk-off (equity/bond) equation, investors are looking to find smarter ways to access higher yielding assets while managing volatility. All investors (institutional and retail) remain acutely aware of the volatility that can be experienced during times of stress.

2. **Diminished appetite for risk:**
   European pension funds and insurance companies are on a long term de-risking journey that started well before the global crisis struck in 2008. Institutional investors had already embarked on a de-risking trend reflecting the introduction of risk-based regulations (e.g: FtK in the Netherlands) and of mark-to-market accounting standards (IFRS). Pension funds and insurance companies, which account for around 60% of institutional assets globally, had already started to reduce their equity allocations in favour of 'liability-matching' assets, typically bonds.

In addition, macro-prudential measures and regulatory changes adopted post- crisis generally favour fixed income investments. Risk-based regulation such as Solvency II and Basel III penalise equity-like investments relative to other asset classes, requiring institutions to hold more capital due to higher potential drawdowns.

The crisis accelerated this de-risking trend, causing both a fall in equities and a sharp decline in bond yields, and consequently a dramatic worsening in the solvency positions of long-term investors. This squeeze on solvency ratios highlighted the need to manage both asset and liability risks more effectively.

In addition to market risks, demographic pressures and ageing populations in many economies weigh further on pension fund liabilities, meaning that there is an increasing focus on regular income and capital preservation, as well as on lower volatility of returns.

The future—using the full spectrum of solutions

So far, therefore, although investors might ordinarily be tempted to try to benefit from improved economic growth by 're-risking', policy uncertainty and regulatory constraints, combined with long-term liabilities and increased longevity, are holding them back. Today, investors are faced with a dilemma: they need growth to recover but cannot afford to take much more risk.

While there has really only been talk of a 'great rotation' into equities to date, we have already seen a rotation within the fixed income universe as retail and institutional investors search for yield. Allocations to non-traditional and/or alternative fixed income assets, and strategies such as high-yield bonds or loans, insurance-linked bonds, real estate loans and alternative fixed income/ credit strategies have been on the rise over the last three years. This is because investors are looking for higher yields but with lower volatility. Alternative investments have this winning combination, as well as appealing correlation features. Re-risking no longer means simply selling out of bonds for equities. In the search for growth with an increased focus on risk management, the investment management industry has developed other solutions that allow our clients the ability to invest in risky assets, but put risk management at the heart of portfolio construction.

First, the industry has improved the identification and measurement of risk in investors' portfolios, second, there are a wide array of tools to mitigate risks that are unrewarded or represent a relatively high opportunity cost for our clients, and third, active management to continually monitor portfolios against long-term objectives, risk budgets and the economic environment will be key.

> While the risk budget and consequently the solution is not the same for all investors, one thing is universally true- risks need to be managed over time

Measuring risk

To position investment portfolios more effectively, investors need to have a better understanding of the type of risks they take on board, by using in-depth risk factor analysis, rather than purely viewing traditional asset class risks.

Each asset class can carry a number of different embedded risks, which explain the majority of their risk and return characteristics. Credit reflects sovereign/ corporate default risk and the direction of interest rates. Equities are not just about pure equity risk but also reflect embedded inflation, commodity and interest rate behaviour.

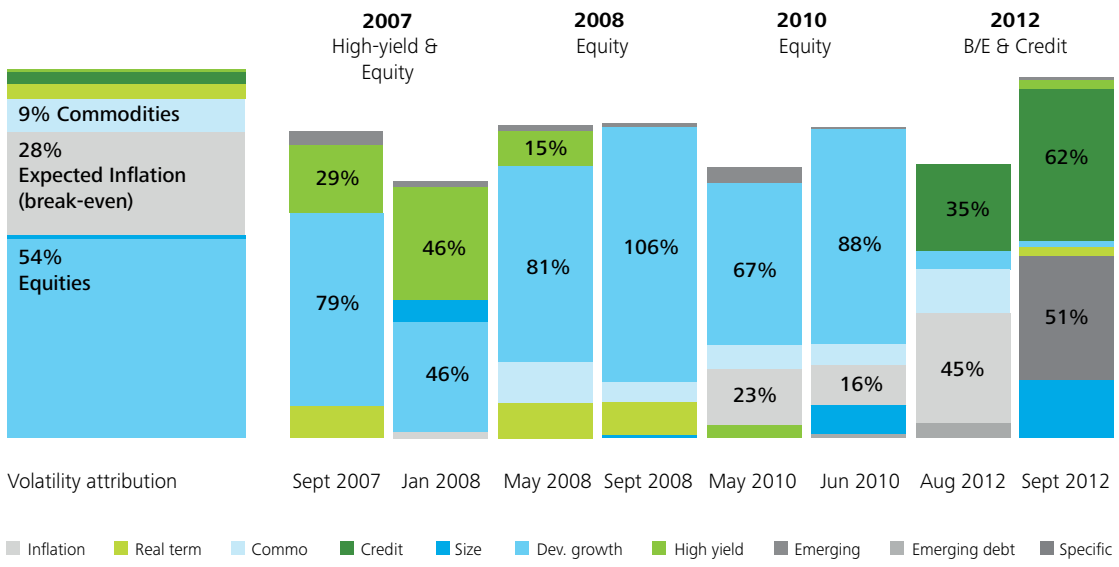
Moreover, this asset's risk typology evolves over time. Diverse asset classes can therefore have unexpectedly high correlations, a result of underlying common risk factor exposures, and need to be continually monitored and assessed as this will change over time.

For example, a UK DB pension fund may allocate, say, 50% of assets into equities and 50% into fixed income, and perceive its risks to be equally split. While on average, around 50% of the portfolio's volatility is represented by equity risk, with the rest coming from inflation, commodity and credit risk, the rolling picture may change significantly, as shown in Figure 1 below. In 2008, for instance, the picture was very different at the start of the year compared to the end of that year.

Therefore, looking beyond the traditional asset class view of risk to the actual risk factors that are driving volatility and returns, provides a more granular view, whether in an asset-only environment or looking at both assets and liabilities.

Raising this awareness enables investors to define what risks they are comfortable with and what risks they want to remove, in order to generate growth within a tight risk budget context.

Figure 1: Risk driven by evolving exposures risk factors



Source: Datastream, AXA IM, proprietary Risk Factors methodology

Managing risk to generate growth

Risk selection is the backbone of any search for growth in the context of long-term de-risking. By hedging some of the embedded risks, investors can free up space to invest in return engines. Once selection is done, investors have a full spectrum of investment tools to properly and efficiently implement the decisions. We can draw on two main categories—those oriented to hedge or mitigate risks (risk focus only), and those that focus on risk management and return generation.

> For most long-term institutional investors, liability risk remains significant and needs to be addressed

1. **Risk mitigation: the use of derivative instruments in overlay management**
   For most long-term institutional investors, liability risk remains significant and needs to be addressed. Overlay management strategies can be used to tackle liability risks more efficiently, but can also be used for hedging specific asset risks, market volatility and tail risk. At its simplest, using derivatives to mitigate liability risk allows for a more capital-efficient way for institutions to manage their portfolios—they can do more for less—hedging their unrewarded liability risks while freeing up capital to be invested in growth assets. Rising inflation, potential equity drawdowns and interest rate moves are examples of risks that could be hedged in a portfolio to free up space for returns.

Risk factor	Investors		Impact			Solution
Rising rates	DB funds	+	↓↓ Liability	↓ Asset	↑ Solvency	Trigger policy to gradually close duration gap
	P&C insurer		↓ Liability	↓↓ Asset	↓ Solvency	Dynamic hedging to mitigate impact on rise
	Life insurer				↑ Lapse	Get exposure (Cap CMS) to enhance yield
Inflation ↑	DB funds	—	↓ Liability		↓ Solvency	Inflation hedging
FX ↑↓	All			↓ Asset	↓ Solvency	FX hedging
Equity ↓				↓ Asset	↓ Solvency	Dynamic hedging to mitigate market shocks

Source: AXA IM, for illustrative purposes only. DB funds = Defined Benefit pension funds, P&C insurer = Property & Casualty insurance companies.

2. **Risk-managed growth engines**
   Given continued economic and policy uncertainties, as well as the impact of an exit from QE, volatility is expected to return. Access to lower volatility growth strategies or strategies that can manage volatility is vital for investors who are trying to stabilise their balance sheets.

   There are various ways to invest in equity or equity-like assets while also mitigating volatility (and often any associated regulatory impact). In the toolbox are smart beta strategies, risk-driven portfolio construction and rebalancing techniques, along with derivatives strategies that can reduce volatility and, in some instances, provide regulatory relief.

- ***Smart beta or efficient beta strategies:*** these strategies offer a new approach to market exposures where the central feature is a reduction in concentration risk. The risks of simply investing statically by blindly following market capitalisation indices were made clear during the crisis. Even when investors did not think they were running a risk, they later realised that they had been exposed in terms of concentration risk—for example, many bond investors had large and inadvertent exposure to financials. Smart beta strategies can help overcome these inefficiencies
- ***Risk mitigation strategies (VolCap, Vol Target)—dynamic rebalancing to manage volatility.*** As detailed above, long-term investors are increasingly concerned by the degree of volatility in their portfolios. In order to stabilise their funding/solvency ratios, asset managers have been working with clients on volatility-managed strategies that dynamically manage the allocation to a particular asset class to benefit from its growth but limit its volatility. Such strategies allow investors to 'target' the level of volatility they can afford to take within a certain asset class by either rebalancing when volatility is too high or increasing allocations when volatility is too low or moves away from the target. Strategies can also be designed to manage the maximum loss experienced by a given asset class

All of these solutions are built primarily according to risk considerations, where the principal goal is risk efficiency rather than a targeted return objective. These solutions can be implemented at a single asset class level or in a multi-asset class approach.

Putting it all together

The crisis reshaped the investment world. This process is not yet finished, as the implications of unwinding unprecedented levels of liquidity and QE are far from certain. Investors are looking to the investment management world to provide solutions to manage this uncertainty. Improvements in regulations, technology and risk management are enabling portfolio risks to be defined, measured and mitigated more effectively.

There is no single solution that fits all investors: Individuals near or at retirement may be looking for capital preservation and income—the risk of losing capital or not attaining the required replacement ratio on retirement. Long-term institutional investors look at risk versus their liabilities—even UK and Dutch funds may differ in terms of their risk appetite. Sovereign wealth funds are less encumbered by regulatory or liability constraints and therefore generally have higher allocations to alternative and illiquid assets, but may have other considerations in terms of ethical investments etc. Any solution will also necessarily reflect the size, agility and governance of the investor.

All solutions should be managed dynamically: While the risk budget and consequently the solution is not the same for all investors, one thing is universally true—risks need to be managed over time. Active management has never been more important than it is today.

> Improvements in regulations, technology and risk management are enabling portfolio risks to be defined, measured and mitigated more effectively

To the **point**:

- Despite signs of a modest recovery, institutional investors are still on a long-term de-risking journey
- Recent equity market rallies have aided investors on that journey, but there is little evidence at this juncture of any long-term 'great rotation' towards typical risk or growth assets (equities)
- As the financial system adapts to the new reality of increased regulation and (potentially) a world without QE, volatility is likely to increase, further limiting investors' risk appetites
- A deep understanding of an institution's prudential and investment framework allied with skilled, active asset allocation is necessary to navigate this new world
- De-risking no longer means simply selling out of equities; re-risking no longer means simply selling out of bonds
- Investors need to access the full toolkit to access growth while managing volatility

Fund governance round-up

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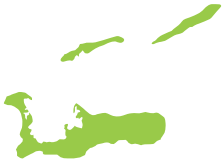
Fund governance continues to be a much debated topic among the wider investment community. In the wake of the financial crisis, governance models are under scrutiny and investor and regulator attention has been focused on key governance aspects such as ultimate responsibility, independence, conflicts of interest and demands for greater accountability, which is being reflected in some notable developments on fund governance from around the globe over the last few months.



Cayman Islands

The Cayman Islands Monetary Authority (CIMA) commissioned the Hedge Fund Corporate Governance Survey earlier this year. The survey was conducted as part of a wider effort by CIMA to gain feedback from hedge fund managers, investors, directors and various hedge fund service providers on proposed corporate governance policy and standards from the local industry and its stakeholders.

The survey (which can be found on CIMA's website at www.cimoney.com.ky) demonstrated that director knowledge, experience and independence were the most highly valued elements of a corporate governance structure. In particular, investors—as evidenced by the survey—place a greater emphasis on director independence than on knowledge and experience. A director's duty is to the fund and, as such, the director's role in the corporate governance structure is to serve as a source of fiduciary oversight. Independence is therefore considered a crucial aspect of a director's ability to perform his/her duties objectively and protect investors' interests. The judgment in the Weavering case in August 2011 served to highlight the need for impartiality on the part of the directors. In this instance, a family relationship between the fund's manager and the directors allowed the fraud to be perpetrated through the directors' wilful failure to discharge their duties to the fund. It was alleged that if the directors had properly discharged their responsibilities, then the fraud would have been discovered and the fund's losses could have been mitigated.

Respondents to the survey were divided on whether there should be a limit on directorships held by each director, and whether this would benefit the industry. Most respondents who believed that this would be beneficial to the industry felt that this should be based on the number of manager relationships and not the number of single directorships held. This was particularly felt by hedge fund managers. Investors expressed concern that directors with a large number of directorships may spread themselves too thinly, and see a limitation on the number of directorships as a means of increasing directors' ability to focus on the efficiency of the due diligence process.

The importance of having sufficient time for this purpose was further echoed by directors. Non-executive directors generally sit on numerous boards for which a meeting is convened periodically. The irregularity of these meetings was seen as a weakness of the industry. The large number of directorships held by a director is therefore seen as a constraint on a director's ability to effectively provide adequate fiduciary oversight. Another key theme which came out of the survey was a need for greater transparency. Investors, in particular, want more information on directors. Investors were particularly interested in the number of directorships held by each director, as well as any previous, current or pending litigation involving the directors.

A director's duty is to the fund and, as such, the director's role in the corporate governance structure is to serve as a source of fiduciary oversight

This information is of great importance to the corporate governance due diligence process, as it is one of the determinants that may be used by an investor to assess whether a director is 'fit and proper' to serve as the fund's director in accordance with the statutory requirements of the Cayman Islands. To achieve this transparency, the majority of investors were in agreement with information on the number of directorships held by directors being provided through a database managed by CIMA. However, directors who agreed with the disclosure of the number of directorships were least in favour of this method of communicating such information. Overall, the survey demonstrates that the Cayman hedge fund industry sees the importance of establishing strong corporate governance standards and practices and a robust regulatory framework pertaining to the Cayman Islands funds sector. Director knowledge, experience and independence continue to be ranked among the key strengths of the local industry, and as such will continue to drive local regulatory policy.

Ireland

The Central Bank of Ireland ('CBI') continues to focus on the conduct of boards and director responsibilities across the financial services sector. The new Governor of the CBI, Cyril Roux, has stressed the importance of individual responsibility on persons operating in financial services providers, and on directors in particular. The CBI has taken a three pronged approach in this regard.

Firstly, all directors are considered to be pre-approved controlled functions under the fitness and probity regime, meaning they must undergo competency, capacity and probity tests by their firm prior to being assessed by the CBI on similar criteria. The time commitment by individual board members, as well as the level of board activity and range of competence and skillsets on the board are areas likely to come under scrutiny in CBI themed inspections during 2014. The CBI has a number of significant powers in this regard, including the ability to fine or disqualify directors that fail to adhere to the requirements.

Secondly, the CBI has begun to flex its powers under PRISM , its new risk based approach to supervision. In particular the CBI has increased the number of inspections conducted in the last year. PRISM inspections may involve interviews of board members, which can be challenging in nature and focussed on technical, risk and strategic matters.

> While the IFIA code is voluntary, the Central Bank considers its adoption 'essential'

Finally, the CBI has adopted a strong stance on adherence to the Corporate Governance Code for Collective Investment Schemes and Management Companies issued by the Irish Funds Industry Association (the 'IFIA Code'). While the IFIA Code is voluntary in nature, the CBI considers it 'essential' that all Irish fund boards adopt the code, with 2013 marking the first full year of compliance following a transitional period. The CBI is now monitoring industry take-up of the IFIA Code and requiring management companies to confirm in their online filings that the IFIA Code has been adopted. Where the IFIA Code is adopted, the annual report should confirm compliance or explain the reasons for not adopting any provision.

The IFIA Code draws on the existing corporate governance practices as outlined in the Central Bank Notices and in the Irish Companies Acts but also includes some significant changes and additional focus relating to:

- Independent directorships
- Time commitment of the board
- Conflicts of interest
- Board performance review
- Attendance at meetings
- Terms of reference for committees
- Director training

The implementation of the Alternative Investment Fund Manager's Directive ('AIFMD') has resulted in the addition of further requirements for the boards of Irish management companies which become authorised AIFMs. The CBI has clarified additional managerial functions for which the board retains responsibility, with individuals required to accept responsibility for monitoring and controlling these activities on a day-to-day basis.

Luxembourg

ALFI (Association of the Luxembourg Fund Industry) issued a revised Code of Conduct in an update to its initial version, which was published in September 2009. There have been many developments in fund regulations and governance over the last four years, partly as a response to the onset of the financial crisis, which led to the need to review and update the Code of Conduct.

The 2013 revision of the Code did not, however, change its overall approach, which remains based on principles rather than detailed rules. As in its initial version, each of the Code's principles is supported and explained by a number of recommendations, which in most cases will represent the practice to be followed by industry participants in order to implement these principles. The revised Code was published on the occasion of the Annual General Meeting of ALFI held on 19 June 2013.

ALFI's Board of Directors strongly recommends that all funds and management companies, whether UCITS or non-UCITS, adopt the revised Code, and that they confirm adherence to the principles of the Code in their annual financial statements. Despite the voluntary nature of the Code, it is interesting to note the wide extent to which the Code in its initial version has already been adopted. According to the most recent and very extensive survey of Luxembourg fund governance published in January 2013, 85% of the UCITS covered by the survey reported that they had adopted the Code and, furthermore, all respondents in the survey declared that the principles-based approach of the Code was appropriate.

In an era marked by the ever-increasing number and complexity of rules and regulations, there is nonetheless a widespread acceptance by industry participants of the need to adopt sound principles of governance underpinned by recommendations for best practice.

As for the revisions to the Code, two additional principles have been added to the eight principles included in the initial version of the Code.

These two new principles (on external governance and remuneration of board members of funds respectively) incorporate the significant regulatory and governance developments in these areas that have taken place since 2009.

The recommendations underpinning the ten principles of the Code have been reviewed and updated to take account, in particular, of the increased focus on the management of conflicts of interest, risk management and internal controls, which have been major features of new regulations and developments in practice since the publication of the initial version of the Code. Additionally, greater focus on the role and the composition of fund boards is reflected in new and revised recommendations covering the role of the chairperson, diversity in board membership, the role of independent directors and the recommendation for fund boards to perform periodic reviews of their performance.

There have been many developments in fund regulations and governance over the last four years, partly as a response to the onset of the financial crisis, which led to the need to review and update the Code of Conduct

United States

In June 2013, the U.S. Securities and Exchange Commission (SEC) issued its findings against the former directors (Morgan Keegan directors) of the Morgan Keegan funds, in connection with the fair valuation of the funds' securities (http://www. sec.gov/litigation/admin/2013/ic-30557.pdf)[1].

The funds heavily invested in below investment grade debt, with the majority of the funds' assets invested in structured products including those backed by subprime mortgages. Often a difficult asset class to value, these holdings became more challenging to price during the relevant period of January through August 2007, due to extreme market conditions, including reduced liquidity and price volatility.

In the Morgan Keegan case, the SEC found that the funds' valuation procedures relied on boilerplate-type factors taken directly from Accounting Series Release 118 (ASR 118). These factors included fundamental analytical data relating to the investment, the market for the securities and the issuer's financial statements. The SEC found that, beyond these factors, the procedures provided no meaningful methodology or other specific directions on how to make fair value determinations for specific portfolio assets or classes of assets.

These factors included fundamental analytical data relating to the investment, the market for the securities and the issuer's financial statements

The SEC also found other issues with the funds' procedures, including the fact that the procedures did not include any mechanism for identifying and reviewing fair valued securities whose prices remained unchanged (so-called stale prices) for weeks, months and entire quarters. Finally, the SEC found that the procedures did not require the Morgan Keegan directors to ratify fair value determinations, and that the Morgan Keegan directors did not ratify such valuations in practice. As is common in enforcement actions, the SEC found that management did not follow the funds' written procedural requirements, including the requirement for the Morgan Keegan directors to receive written explanatory information in support of the fair valuations assigned. The SEC also found that while the funds' procedures required fair value decisions to be made by a management valuation committee, fair values were assigned in practice by the fund accounting group, with significant influence from the portfolio manager.

In the case, the SEC found that fair valuation decisions were made with significant input from portfolio management. In this regard, the SEC found that the Morgan Keegan directors did not receive information on management 'overrides' of prices provided by a pricing service or broker-dealers. More broadly, the SEC found that the information and reports provided to the board did not provide sufficient information for the Morgan Keegan directors to understand what methodologies were used to calculate the fair value of the funds' securities.

The SEC also used the case as a platform to reiterate its long-standing position that fund directors are ultimately responsible for fair valuations and that directors must actively ensure that fair valuations are appropriate and related processes are working as intended[2].

1 *The SEC found that the Morgan Keegan directors caused the funds to violate Rule 38a-1 of the Investment Company Act, which requires registered investment companies to adopt and implement written policies and procedures reasonably designed to prevent violation of the federal securities laws, including policies and procedures that provide for the oversight of compliance by the investment adviser. The case against the Morgan Keegan directors follows an SEC settlement with management concerning the funds' valuation practices. See http://www.sec.gov/litigation/admin/2013/ic-30557.pdf.*

2 *See section 2(a)(41)(B) of the Investment Company Act, which requires the board to determine a security's fair value in good faith when market values are not readily available, and Accounting Series Release No. 118, Investment Company Act Release No. 6295 (December 23, 1970) regarding the SEC's interpretation of this requirement.*

Retrocessions
A thing of the past?

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Ever since the global financial crisis and the European debt crisis, regulators have been scrutinising the financial services sector and implementing legislation to make the industry more transparent and accountable. The latest wave of regulations that address the asset management business model is no different.

With MiFID II on the way and similar regulations in non-EU jurisdictions, the asset management industry is being forced to undergo a major transformation. One widely-debated topic has been the fee structure of advisors, particularly the ban on inducements. Regulators across Europe see these fees as non-transparent and are taking measures to either ban retrocessions outright or drastically reduce them through stringent controls.

The 27 EU member states will likely be allowed their own inducement approach, but either way the directive is calling for radical change. The Netherlands, Denmark and United Kingdom, for example, have decided to implement a complete ban on inducements. Such regulations are resulting in fundamental changes to the way in which financial advisors and asset managers operate, forcing them to re-evaluate their entire business models.

EU and the Markets in Financial Instruments Directive (MiFID) II

The aim of MiFID II is to help move the EU towards a more unified, competitive and transparent financial services industry. The 'trialogue' between the European Union's Council, Parliament and Commission is shortly expected to reach a conclusion on a final directive, which could require transposition by EU member states by 2015. MiFID II broadens and refines MiFID I (in place since 2007) and will have a fundamental impact across the European securities markets. More specifically, MiFID II focuses on thirteen key strategic topics, one of which relates solely to the use of inducements, or retrocessions. Historically, fund managers have offered financial advisors hefty commissions or retrocessions, which are fees charged to the fund and therefore an indirect cost to the investor.

Under the current revision of MiFID II, advisors will no longer be allowed to accept any monetary or non-monetary benefits paid by any third party, except for minor non-monetary benefits—but only if they improve the quality of service and do not prevent the firm from acting in the best interest of the client[1]. In addition, advisors will have to disclose all management fees and upfront fees.

Furthermore, MiFID II's revised definition of independent investment advice states that financial service providers will only be able to claim independence if they do not receive any form of remuneration from third-party providers.

1 *European Council, June 2013, Article 24*

Impact of MiFID II

1. **New business models**
   Under this new legislation, banks will need to start charging an explicit advisory fee to clients and/or increase the brokerage fee to replace the lost revenue from retrocessions. Changing the fee structure could impact the business model in different ways. First, the new fee structure will likely lead to fewer advisors, as clients may be unwilling to pay these advisory fees. In this scenario, clients may decide to bypass the advisor entirely and go directly to the asset manager via online platforms. Second, the client may still seek traditional types of advice from an advisor but that client base is likely to be far smaller and primarily affluent or high net worth. Third, new lower cost advice models will need to be developed whereby less affluent customers obtain guidance on their investments rather than a full advice service.

2. **High margin products likely to suffer**
   We believe that these changes are also likely to impact the more sophisticated investment products where banks benefit from the highest margins. More complex products logically call for higher fees due to higher costs, uniqueness and complexity. Since the new legislation mandates that these fees be explicit, client demand for these products is likely to decrease unless true value is being delivered to the client. The industry has already suffered a substantial decrease in demand for complex products subsequent to the financial crisis, when preferences shifted towards more transparent and simpler products. Overall, a further reduction or elimination of fees from high margin products is likely to worsen the profitability problems of many asset managers.

Regulators across Europe see these fees as non-transparent and are taking measures to either ban retrocessions outright or drastically reduce them through stringent controls

UK and the Retail Distribution Review (RDR)

The United Kingdom is one of the three European jurisdictions to prohibit inducements and implemented this change through RDR, a new legislation which came into effect just over a year ago (31 December 2012). The UK's Financial Conduct Authority (FCA) introduced this mandate to a) end conflicts of interest in the financial advisor payment structure, b) increase transparency in respect of how investors pay for their financial advice and c) strengthen the professional qualifications of advisors and clarify the type of advice they provide[2]. Under the new regulation, financial advisors (and platform operators as from 6 April 2014) are no longer allowed to receive commissions from fund managers on new business. Instead, all retail investment advisors must develop an upfront fee structure and disclose it to investors. Deloitte research has predicted that as a direct result of this new fee structure, up to 5.5 million people in the United Kingdom would either become unable or unwilling to pay for financial advice (also called the advice gap)[3].

Before RDR even came into effect, some of the UK's largest financial institutions had already announced their plans to withdraw advisor services from the mass market segment, including Lloyds Banking Group, HSBC and Barclays[4].

Shortly after RDR came into effect, Aviva and Axa also announced they would discontinue advice as well, further impacting other players. In the year leading up to the implementation of RDR, the total number of bank and non-bank advisors dropped by 44% and 20%, respectively[5].

In addition to the ban on inducements, in October of last year, the FCA decided to further investigate fund charges, particularly the cost of third-party research and other fees. Currently, asset managers pass these fees onto the investors via management fees. The head of the FCA, Martin Wheatley, told the Financial Times that asset managers have 'stretched the definition' of what they can use commissions to pay for[6]. If the UK goes forward with legislation to unbundle management fees, it would be the only country in the world to do so, and it would likely lead to a decrease in asset managers buying research.

One implication could be that active portfolio managers, who have a tendency to depend on research to be successful, will be negatively impacted, whereas passive managers could benefit.

2 *Financial Services Authority (FSA), 'FSA details the enhanced standards people can expect from all investment advisers,' (2009) <http://www.fsa.gov.uk/pages/library/communication/pr/2009/082.shtml>*

3 *S Cohen, P Evans and A Power, 'Bridging the advice gap: Delivering investment products in a post-RDR world' (2012) < http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-bridging-the-advice-gap.pdf>*

4 *A Power, 'Recognising RDR Reality: The need to challenge planning assumptions' (2013) < http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-recognising-rdr-reality.pdf>*

5 *N Holt, 'First official RDR stats: adviser numbers down 20%, bank advisers fall 44%' (2013) < http://www.moneymarketing.co.uk/first-official-rdr-stats-adviser-numbers-down-20-bank-advisers-fall-44/1068505.article>*

6 *S Fleming and D Oakley, 'Shake-up on charges for UK asset managers' (2013) < http://www.ft.com/intl/cms/s/0/59b33776-40ca-11e3-ae19-00144feabdc0.html#axzz2keldHPB8>*

Impact of RDR

In our view, the ban has led to the following five key changes:

1. **New fee structure**
   As a result of RDR, the advisory industry has been forced to re-evaluate its fee structure and find a cost-effective solution. Different schools of thought have emerged as banks and advisors try to find the right formula. Some of the new fee structures include: hourly rates, percentage of funds invested and annual flat fees[7]. This fee-for-service structure is also shifting advisor behaviour. Rather than trying to beat the market or aggressively sell a product, advisors are amending their propositions to something they can better control and that is aimed more at financial planning[8].

2. **More clients going direct**
   Alternatively, many retail clients are choosing not to pay for financial advice, instead opting to either use online platforms or go direct. According to Deloitte Research, this growing segment currently represents approximately 20% of the wealth market, a total of around £450 billion in Assets under Management (AuM), which is likely to grow by another £125 billion as a result of the advice gap[9]. This growing trend to go direct is causing concern among the regulators. In fact, in September 2013, Wheatley expressed concern over the advice gap: 'It is a concern that people with portfolios below £50,000 to £100,000 are not getting the same service they were getting'[10]. To take advantage of this opportunity, players in the non-advised market will need to differentiate themselves by targeting specific client segments and implementing a pricing strategy that is both competitive and profitable, despite the ban on rebates[11].Those that can implement new, innovative solutions to target the mass market will win.

3. **Tailored approach for mass market**
   Banks and asset managers need to focus on improving their operational efficiency. At the current rates, the client base for advisors is quickly shrinking. In order for advisors to hold onto a larger portion of their affluent customer segment, they need to further tailor their approach and offer services with lower fees that are most closely aligned with the sophistication of client needs and the willingness to pay. Getting client segmentation right is more important than ever.

4. **Passively managed products are benefiting**
   Passively managed investment products are receiving more attention owing to the increase in transparency. Previously, the low charges on these products meant they could not afford to pay retrocessions so were rarely recommended by advisors. In the new environment, advisors no longer have this distinction and can use lower cost, passively managed products to appeal to customers who might object to paying advisor fees.

5. **Development of clean share classes**
   Investment managers have had to develop clean share classes that strip out commission and platform fees. A significant debate is under way regarding whether all clients should be switched into these lower cost share classes automatically or if they can be kept in traditional share classes as the commission reflects advisory services provided in the past. Tax plays a key role in whether such a switch is beneficial to a customer.

Switzerland: lawsuits, FINMA publications and the Financial Services Act (FSA)

A number of factors, both at home and abroad have created a heated debate in Switzerland about the use of retrocessions. In Switzerland, two civil lawsuits have triggered widespread debate. The most recent was a civil lawsuit that took place in October 2012 against UBS, whereby a client made a claim for the retrocessions his advisor received. In this landmark ruling, the Swiss Federal Supreme Court ruled in favour of the claimant and ordered UBS to reimburse the fees with retroactive effect. The judgment makes it clear that investors are entitled to all commissions and/or retrocessions that banks receive from funds. If the bank fully discloses all fees, clients still have the choice of whether or not to waive their right to make any such claims.

In line with these court rulings, and in light of developments across the EU, Switzerland's watchdog, the Financial Market Supervisory Authority (FINMA), published a Position Paper in February 2012 on distribution rules, which stipulates that banks must inform clients of any remuneration received from third parties or from within the company. This implies that in certain cases, banks could be required to disaggregate bulk rebates the bank may have received from funds in order to determine how much is owed to a specific individual. In a similar way to MiFID II, the Position Paper also states that advisors may only claim independence if they do not receive any third-party incentives. In addition to the Position Paper, FINMA published a revised Circular on the 'Guidelines on asset management' (which took effect on 1 July 2013) that sets forth specific guidelines for asset managers to follow as a minimum standard for rules of conduct.

7 Financial Conduct Authority (FCA), 'Supervising retail investment advice: how firms are implementing the RDR' (2013) <http://www.fca.org.uk/static/documents/thematic-reviews/tr13-05.pdf>

8 N Blake, 'Why it's too early to call a result to RDR' (2013) <http://www.ifaonline.co.uk/ifaonline/feature/2296781/why-its-too-early-to-call-a-result-to-rdr>

9 A Power, 'Recognizing RDR Reality: The need to challenge planning assumptions' (2013) < http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-recognising-rdr-reality.pdf>

10 S Dale, 'Wheatley admits 'concern' over post-RDR advice gap and hints at action' (2013) <http://www.moneymarketing.co.uk/wheatley-admits-concern-over-post-rdr-advice-gap-and-hints-at-action/1077089.article>

11 A Power, 'Recognizing RDR Reality: The need to challenge planning assumptions' (2013) < http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-recognising-rdr-reality.pdf>

With MiFID II on the way and similar regulations in non-EU jurisdictions, the asset management industry is being forced to undergo a major transformation

More specifically, it establishes additional requirements for asset managers to inform clients of the 'calculation parameters and spread of inducements they receive or might receive', as well as to disclose the amount of any inducements already received at the request of the client.

Despite FINMA's publications, many issues remain unaddressed by the law. New legislation is therefore under way under the Financial Services Act (FSA), which will ultimately determine the use of retrocessions. Implementation is not expected before 2015. Market expectations are that a compromise with strict conditions is more likely than an outright ban.

Impact of the lawsuits and the FSA

The reimbursement of retrocession fees on a retroactive basis will vary from bank to bank but the impact will be sizeable. According to Reuters, independent asset managers in Switzerland have earned approximately CHF 7 billion in retrocessions over the last five years, of which a large portion is at risk of being owed to the client[12]. In fact, the exposure could prove to be even greater, as the retroactive effect is still being debated (it will be either five or ten years). Although the highly integrated financial services companies will likely face the biggest bills, smaller asset management firms may find it hard to fund the rebates.

As a result of these events, UBS became one of the first Swiss banks to eliminate retrocession fees associated with products sold to discretionary private clients, and will phase them out by the end of 2013[13]. Credit Suisse and AKB have also decided to phase out retrocessions, by 1 July 2014[14] and 1 January 2014[15], respectively. In addition, many asset managers are also reacting to the new landscape. For example, Swisscanto, the Berne-based asset manager owned by Switzerland's cantonal banks, has created commission-free share classes for both qualified and discretionary investors[16].

Conclusion

Regardless of your jurisdiction, there is a clear regulatory trend sweeping across Europe to move away from retrocessions and towards a more transparent, upfront fee structure. The following are three ways for asset managers to respond:

- If you have advisors in-house: sell your products and earn advisory fees on asset management products
- If you do not have retail distribution: brand, performance, price or meeting investor requirements are the few remaining ways to raise your profile with retail investors not using advisors
- If your products are not performing, you will be exposed—more rationalisation and a stronger emphasis on passive products might be the only way

12 *M de Sa'Pinto, 'Swiss asset managers sweat over UBS fee ruling' (2012) <http://uk.reuters.com/article/2012/11/12/swiss-investment-fees-idUKL5E8M97RB20121112>*

13 *NUBS Press Release, 'Revised pricing structure for discretionary mandates' (2013) <http://www.ubs.com/global/en/about_ubs/about_us/news/news.html/en/2013/03/13/20130313a.html>*

14 *'Credit Suisse verzichtet auf Retrozessionen' (2013) <http://www.nzz.ch/aktuell/wirtschaft/wirtschaftsnachrichten/credit-suisse-verzichtet-auf-retrozessionen-1.18177022>*

15 *'Auch AKB leitet Retrozessionen weiter' (2013) <http://www.handelszeitung.ch/unternehmen/auch-akb-leitet-retrozessionen-weiter-522253>*

16 *D Ricketts, 'Switzerland plans crackdown on rebates' (2013) <http://www.igniteseurope.com/c/578394/65254/switzerland_plans_crackdown_rebates?referrer_module=emailMorningNews&module_order=0&code=WVdKaGRXTm9ZWFJBWkdWc2IybDBkR1V1YkhVc0lERXdNekV4T0RRc0lERXdPVEUyT1RNM09UWT0>*

To the **point**:

- Across Europe, retrocessions are likely to be either banned or highly restricted in the next one to three years
- The traditional advisory business model is at risk, but careful segmentation and new, innovative propositions can help distributors retain their client base
- In countries with inducement bans already in place (e.g. the UK), we have seen a significant shift in consumers preferring to go direct
- In countries without retrocession legislation already in place (e.g., Switzerland), we have seen banks and asset managers take pre-emptive action to reposition themselves ahead of the changes—deciding how to prepare for this shift should be a key priority for each asset manager

The 27 EU member states will likely be allowed their own inducement approach, but either way the directive is calling for radical change

Exploring evolving risks and challenges

Perspectives from the investment management industry

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Based on the results of Deloitte's Global Risk Management Survey, eighth edition

Enough time has passed since the height of the financial downturn to provide us with an opportunity to look back and review not only how risk management practices have changed in its aftermath, but also how risk management needs to evolve further to address growing and emerging risk areas.

Unsurprisingly, our survey findings indicate a heightened focus on governance and oversight, as well as a greater emphasis on managing liquidity, investment, credit, regulatory and reputational risks. However, the broader implication is that this necessary focus has also led to management shifting attention and resources away from other risk areas, particularly in the area of operational risk and some of the growing and evolving risks that the industry faces today.

Through the eighth edition of Deloitte's Global Risk Management Survey of financial services firms, we will explore these trends in the context of investment management. Half of the 86 respondents identified themselves as either stand-alone investment managers or investment managers of larger integrated financial institutions (primarily banks and insurance firms).

The Global Risk Management Survey, eighth edition, assesses the state of risk management and covers today's challenges and evolving needs. The survey was conducted from September to December 2012 with the participation of chief risk officers or their equivalents at 86 financial institutions from around the world that manage aggregate assets of more than US$18 trillion

As used in this survey report, 'Deloitte' means Deloitte Touche Tohmatsu Limited and its member firms.

Lessons learned: how risk management has evolved

Governance and oversight

The strategic importance of risk management and the potential for reputational harm were flagged by the 94% of respondents who stated that their boards and/or executive management teams are spending more time on the oversight of risk compared to five years ago. Another key indication of the heightened focus on risk came from the 80% who said their boards now review and approve their organisation's risk management policy and/or Enterprise Risk Management (ERM) framework, as well as their risk appetite statement. In the context of private equity and hedge funds, risk committees or working groups are increasingly taking on a role similar to the responsibilities of a board in other firms.

We have also seen significant growth in the adoption of ERM programmes. In this year's survey, 62% of organisations reported having an ERM programme in place, up from 52% in 2010 and 36% in 2008. An additional 21% of financial institutions indicated that they are actively building an ERM framework. To put that in context, firms that have built or are presently building an ERM framework total 83%, representing a significant shift in the number of firms that are seeking to view and manage risk more holistically, versus the minority of firms who had an ERM programme in 2008.

When asked about their effectiveness at managing specific risk types, most institutions rated themselves as extremely or very effective in managing liquidity risk (85%), credit risk (83%), counterparty risk (83%), regulatory/ compliance risk (74%), and market risk (72%). However, fewer than half of the firms (45%) gave themselves a high rating for operational risk management —strikingly similar to the 47% recorded in 2010. This finding underscores the inherent complexity of managing and measuring operational risk, and strongly suggests that there is still room for improvement in this area.

Other survey highlights

Other macro themes across the broader financial services landscape have emerged that are worth noting:

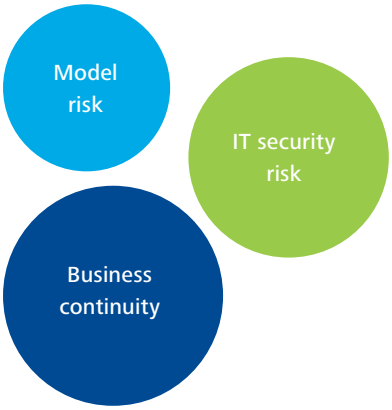
- ***Improvement in risk management capabilities:*** Almost three out of four risk managers rated their institution as either extremely or very effective at risk management overall, an increase from 66% in 2010's survey results.
- ***Firms continue to invest in risk management:*** Two- thirds of financial institutions (65%) reported an increase in spending on risk management and compliance, up from 55% in 2010. The majority of institutions participating in the survey (58%) plan to increase their risk management budgets over the next three years, with 17% anticipating annual increases of 25% or more
- ***Technology and data are a significant challenge:*** Technology used to monitor and manage risk is a particular concern and, according to our findings, significant improvements in risk technology are needed Less than 25% of institutions rate their technology systems as extremely or very effective, while 40% of institutions are concerned about their capabilities in the management of risk data.
- ***Opportunity for greater alignment of risk taking and compensation:*** Progress in linking risk management with compensation has changed only incrementally since 2010's survey results. Currently, 55% of institutions incorporate risk management into performance goals and compensation for senior management, which is little changed from 2010.

Addressing emerging risk areas

In addition to reporting difficulty managing operational risk, many of our survey respondents acknowledged that their risk management approach needs to improve to more effectively address certain growing and emerging risks.

Of more than two dozen risk areas, we asked survey respondents to rate their effectiveness in managing three emerging risk areas—model risk, IT security risk and business continuity—which ranked near the bottom. In each case, only half of the participants judged their organisations to be effectively managing those risks.

Three emerging risk areas



The strategic importance of risk management and the potential for reputational harm were flagged by the 94% of respondents who indicated that their boards and/or executive management teams are spending more time on the oversight of risk compared to five years ago

Model risk management

In our experience, as more investment managers leverage model-driven trading strategies and have a greater reliance on valuation and risk models, they are grappling with a variety of questions including:

- Do our models execute as intended?
- How do we best monitor compliance with investment objectives?
- In the event of an issue, what do we disclose and when?
- How do we appropriately protect the intellectual capital associated with our model?

Beyond the significant risks of monetary loss, regulatory breaches and the potential loss of intellectual capital, some model-driven strategies can and have exposed investment managers to serious reputational harm. Investment managers took notice when the Securities and Exchange Commission (SEC) charged three entities with securities fraud for concealing a significant error in the computer code of the quantitative investment model that they use to manage client assets. The error caused US$217 million in investor losses that were repaid along with an additional US$25 million in fines.

The challenge is that model risk—or the risk that an institution may experience adverse consequences from a decision or action based on using a model—can arise from a variety of sources, including the inconsistent specification, application and implementation of a model. This applies not only to model-driven trading strategies, but also to quantitative models used for valuation, trade allocation and risk management. This broad array of inherent risks and the severity of potential consequences are likely key factors in survey participants' low confidence in model risk management capabilities: of the 61% of our survey respondents who said model risk was now included in their ERM programme coverage, only 50% believe they are effectively managing it.

Industry response: our experience

To address model risk, some of the areas where investment managers are focusing their attention are model governance, model validation, deployment and maintenance.

Governance

Within governance, they are assessing their oversight and monitoring practices, roles and responsibilities, policies and procedures and overall control framework. In addition, when considering the complexity of the model and the potential for key-person risk or if a third party is involved, stringent documentation on how the model executes becomes paramount.

Model validation

This includes reviewing the theoretical design of the model, the data inputs/assumptions and the output compared to the intended use and context of the overall model strategy. Firms are using ongoing monitoring to highlight divergences between actual and expected performance. Firms are also looking to independent examiners to validate and recalculate the models utilising stress and back testing.

Deployment and maintenance

Many firms are enhancing the process and rigour around the model's development life cycle. Primarily this is seen through change management controls and procedures, model integration into existing systems, processes and procedures and the architectural modifications required to support model deployment.

Cyber security and data privacy

Cyber threats continue to evolve in a number of different ways. In the past, talented hackers worked alone or in small groups, often with limited access to resources and their aspirations were more often than not fame and notoriety rather than financial gain. Today's threats are more calculated, targeting systems that hold personal and financial information, as well as intellectual property that can be monetised into huge sums on the black market. Attackers may have significant resources at their disposal (organised syndicates and potentially state-sponsored groups), taking advantage of advances in technology that automate large-scale information collection and the vast amounts of data made available through the popularity of social media and other outlets. In addition, politically motivated attacks or 'hacktivism' pose additional concerns for high-profile institutions, as evidenced by recent denial of services attacks that caused disruption to financial services institutions' consumer-facing websites.

In the past, it was a common understanding that many threats arose from insiders. However, the figure of 40% for breaches in which attackers gained access through third-party systems should catch investment managers' attention.

This reinforces the need for investment managers to understand their extended enterprise and the control frameworks that service providers have in place to address cyber security

Industry response: our experience

A leading practice among investment managers is to better understand their potential exposure by conducting a cyber threat assessment. Such assessments typically entail six key steps:

1. Analysing the organisation's internet-facing systems
2. Identifying indications of existing system compromises
3. Assessing sensitive data across the organisation and whether it is vulnerable to internet access
4. Analysing vulnerabilities related to employees' access to sensitive information
5. Identifying potential targeting by external cyber threat actors
6. Uncovering other unsecure practices, such as the use of unencrypted transactional websites

The investment management industry's reliance upon service providers heightens the need to consider all six components above in the context of their extended enterprise, considering their provider's resources, processes and infrastructure as potential points of exposure.

Superstorm Sandy and subsequent regulatory scrutiny have prompted many firms to re-evaluate or adjust their strategies for dealing with extended disruptions

Business Continuity Management (BCM)

BCM has been challenged in the past through a number of events, including technological, natural and unfortunately, terrorist activities. The base assumption was that significant improvements had been made, which is most likely accurate, but Superstorm Sandy brought BCM practices back into the spotlight for many financial services organisations.

In the investment management sector, the effects of Superstorm Sandy could be seen in the quarter-end timing and the duration of the disruptions, which stressed many investment management firms' ability to calculate net asset value, generate reporting and satisfy client requirements. This is reflected in the survey, whereby only 52% of the firms surveyed felt they were as effective as they could be in managing business continuity.

Industry response: our experience

The regulators have taken notice as the SEC, the Commodity Futures Trading Commission and the Financial Industry Regulatory Authority have issued a joint leading practice statement on business continuity and disaster recovery in response to Superstorm Sandy. Subsequently, the SEC also issued findings based on examinations of business continuity plans of selected advisors affected by "operational disruptions caused by weather-related events last year." These reports highlighted some of the following areas:

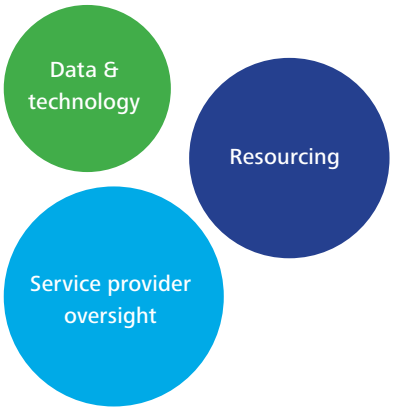
- Scrutiny of vendors, with a rating assigned to them on their BCM preparedness
- Logistics such as communication plans and the need for alternative locations, particularly plans that take into account the possibility of a geographically widespread outage
- Regulatory compliance, particularly in being able to meet regulatory obligations and ensuring BCM plans are updated to include any regulatory changes
- Periodic review, testing and training that is conducted at least annually

In the aftermath of Superstorm Sandy, we have seen BCM and disaster recovery become a matter for the risk committee, which, in some cases, has even been elevated to board level. Many firms are re-evaluating or adjusting their strategies for dealing with extended disruptions, as Superstorm Sandy provided a number of data points to gauge the effectiveness, in practice, of existing plans, as well as employee response. Given the recent regulatory notice, it is likely that there will be renewed focus on the controls, procedures and service provider oversight associated with BCM.

Responding to key challenges

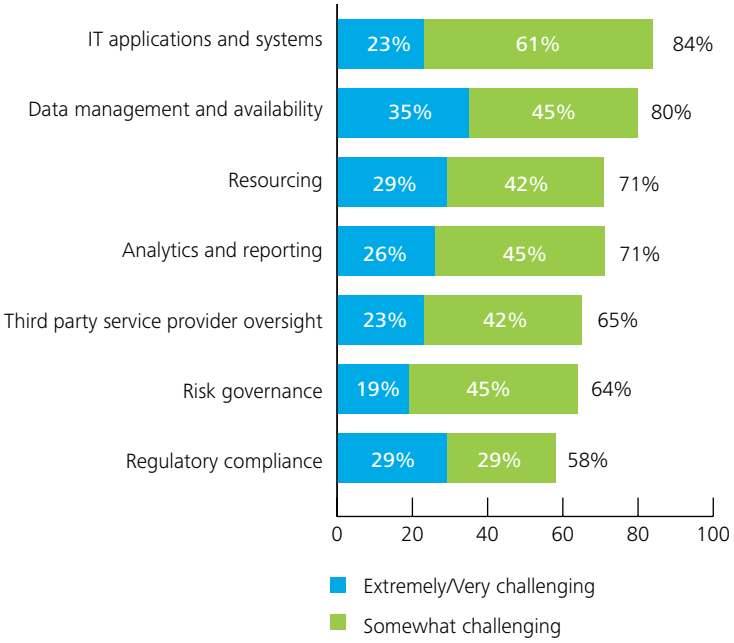
We have discussed some of the emerging risks facing our industry, but our survey also highlights a variety of challenges and inhibitors to managing risk effectively that are specific to firms providing investment management services. These range from data and technology, resourcing and service provider oversight. We have selected a few of these challenges to explore further.

Three key challenges



How challenging are each of the following for the investment risk management function in your organisation?

Risk management challenges



Challenge: data and technology

As indicated in our introduction, one of the key findings in the survey is that the technology used to monitor and manage risk is a top priority across the financial services industry, including investment managers. Investment management firms face significant system, infrastructure and data challenges that occur for a variety of reasons, including the traditional silos encountered among functions, mergers and acquisitions, product development and overall adaptation to changes in the marketplace. These challenges are compounded by the investment manager's fund and account structures and the reliance on service providers for technology and data. Data quality and consistency can be somewhat problematic as a result, as evidenced by the 79% of the respondents to the survey who indicated they were somewhat or extremely/very concerned about data quality and management. 'Garbage in/garbage out' may be an old adage, but data quality is still clearly affecting the ability of organisations to assess, monitor and mitigate risk.

An area of considerable concern across the financial services industry is reference data. For investment managers in particular, the financial downturn exposed both the challenge of determining counterparty risk and the importance of being able to look through transactions to consistently identify legal entities engaged in financial transactions. Post-downturn, the G20 mandated the Financial Stability Board (FSB) to work on the long-standing industry need for a unique, global and standard Legal Entity Identifier (LEI), in order to help assess systemic risk and aggregate risk at an entity level. The FSB, along with many industry participants, has defined the format for a standard LEI and proposed a federated approach to distributing LEIs. Subsequent phases of LEI implementation will include hierarchy data, which will provide additional information to calculate counterparty risk. Ultimately, adoption of LEI across the industry should greatly enhance counterparty risk management capabilities for investment managers, but at a significant cost: not only will reference data need to be mapped and transformed, but existing data stores and operational, accounting and risk infrastructure will need enhancement to accommodate the LEI.

There are also increasing technology and data needs associated with investment compliance monitoring in light of the impact on the investment management industry of the recent introduction of the Foreign Account Tax Compliance Act, Form PF and the Alternative Investment Fund Managers Directive. It is therefore unsurprising to see that more than three quarters (78%) of respondents are concerned about the ability of their technology systems to adapt to regulatory requirements. These significant regulatory changes require coordinated cross-functional efforts from the risk, compliance and IT functions, as well as from the service providers who often provide component pieces (e.g. data/technology) to meet these challenges. This can be further exacerbated for investment management firms that already have a global footprint and are subject to multiple regulators and jurisdictional requirements.

The irony is that while the survey indicates data and technology is a very significant challenge to effective risk management, it can also be its single largest enabler. It can often be extremely difficult to effectively gauge the ROI upfront in respect of the implementation of a potentially large, complex, budget and resource-intensive technology initiative. This is versus the opportunity cost of not implementing initiatives that can yield more effective risk management, scalability to meet product and client demands and increased capabilities globally. That said, it appears that many of the survey respondents have made up their minds in this regard, as enhancing risk, data, infrastructure and technology capabilities has become one of the main investment priorities for institutions.

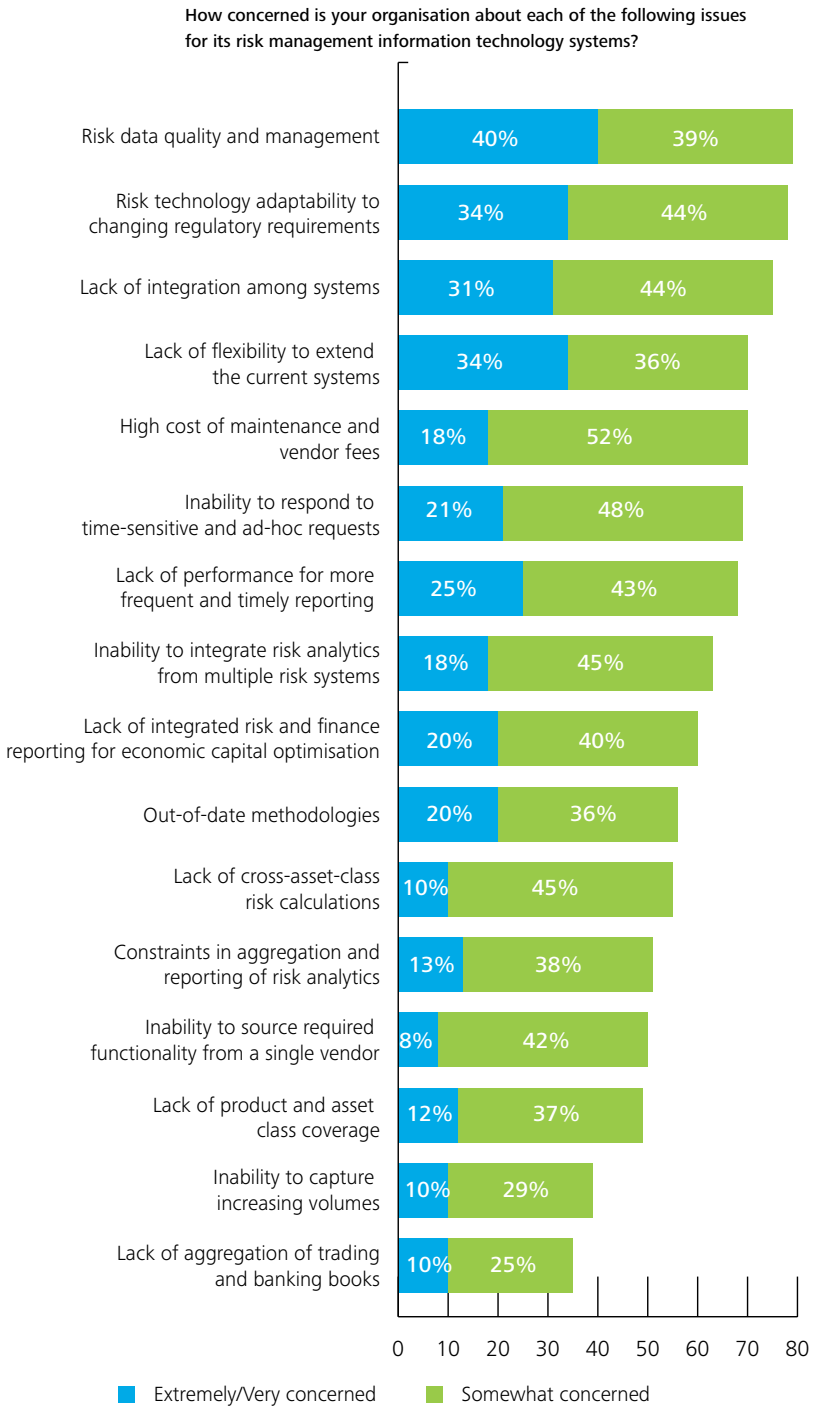
Industry response: our experience

To address deficiencies in infrastructure, a chief goal of the investments that firms are making is to improve the quality and consistency of risk data, with nearly half of those surveyed (46 per cent) planning to make significant investments in this area over the next 12 months. In fact, data-driven investment has grown markedly since 2010: risk data quality and management was ranked as a priority by 63% of respondents in this year's survey, up from 48%, while enterprise-wide risk data warehouse development increased to 51% from 35%.

In our experience, the timeliness, availability and quality of reporting is not only of greater importance internally for decision-making processes by investment managers—larger and more sophisticated institutional investors or parent organisations are requesting that individual managers make data extracts available for consumption by their own risk processes and infrastructure. While data warehouses have been a focus area for some time, they have not proved to be a 'silver bullet' to solving risk data quality issues. One of the biggest challenges to improving and maintaining data quality is to make sure it is already 'clean' and accurate when it is placed in the data warehouse.

Even though tools to catch errors on input, such as missing or inaccurate data fields, have been available for some time, many organisations have not implemented error detection processes or assigned responsibility for data quality. As a result, data governance is emerging as an important area of focus for investment managers so that these issues can be addressed. The chief data officer is a position we are seeing more often at investment managers, with the responsibility to implement the processes needed to improve overall data quality and integrate business user accountability for the integrity of that data. Lastly, addressing data challenges is paving the way for more sophisticated risk analysis, monitoring and reporting. Advancements in enhanced risk and scenario analysis capabilities, including wider product coverage, richer visualisation, and the speed and availability of data are key requirements driving technology investment to support risk management. Although real-time risk analytics and risk aggregation may be relevant or feasible only for a handful of managers with strategies that rely upon high volumes and algorithmic calculations, the technology advancements driving these capabilities can benefit a broader audience. For example, for investment managers with complex, structured products, technologies such as in-memory processing and grid computing can create the difference between canned, T+1 risk data produced in an overnight batch versus flexible scenario analytics, rendered in visualisations that can be refreshed intraday, providing proactive support for the decision-making process.

These investments primarily seek to improve and enhance the capability of the risk function, among others, but also to allow risk professionals the opportunity to relinquish a burgeoning cottage industry in data management to focus on their core competency, which is managing risk.



Challenge: resourcing

Doing more with less is a familiar prospect for most of those in our survey universe, and this task is more onerous today given the increasing intersection of risk and compliance due to regulatory demands and global operating models. This is placing a premium on resources with the right skills to manage day-to-day risk while accommodating growing and emerging risk areas. Indeed, 71% of respondents consider resourcing to be a somewhat or extremely/very significant challenge.

Industry response: our experience

In the investment management industry, we are increasingly seeing a shift to risk- based resourcing—or the allocation of resources to key focus areas as a result of strategic risk assessments designed to maximise the impact and value to the firm. The growing use of formal risk assessments has empowered organisations to compare and contrast risk exposures across areas that were traditionally managed in silos. As a result, resource allocation decisions that were historically determined by the loudest voice in the room or the potential for revenue generation can now be made with a more holistic view of organisational exposure (where the risk lies) and the ability to realise the strategic goals of the organisation. It has also highlighted skill-set gaps (industry-based and competency), leading to more informed hiring decisions and more effective management of key risk areas. In short, risk-based resourcing is levelling the playing field and delivering enhanced allocation of a firm's most precious resource—people.

Challenge: service provider oversight

Financial firms face a variety of risks associated with their reliance on service providers, including a failure to perform against performance standards and contractual obligations, theft, or inadvertent release of client-identifying data, dissemination of intellectual property (such as on strategy or trades) and regulatory breaches (e.g. of anti-money laundering requirements) and counterparty risk.

Although most firms in our survey are satisfied with their service providers, some believe they face a significant risk of non-performance and have strengthened their vendor risk management programmes accordingly. Thus, 40% of firms believe they have high potential exposure to the risk of non-performance by their custodian and 35% attribute this risk to their administrator. In addition, 23% and 20% felt they had high exposure to potential non-performance by their prime broker and transfer agent respectively, while only 13% felt they had high exposure to potential non-performance by their distributor.

Industry response: our experience

Some investment management firms are working to gain a more holistic view of their extended enterprise by evaluating and trying to gain a better understanding of the risk profile of each service provider. In addition, they are establishing a service provider oversight framework aligned with their overall risk profile, which incorporates the following considerations:

- Level and frequency of oversight
- Design of controls
- Active versus latent monitoring
- Key risk indicators
- Adherence to service-level agreements and contract terms
- Use and reliance on third-party reports (e.g. SSAE 16, Financial Intermediary Controls and Compliance Assessment, FICCA reports)

A specific new challenge for many investment managers has been created by the growth of omnibus practices in the shareholder servicing model, as traditional distribution partners join the ranks of the service providers. This fragmentation of transfer agent services has driven some firms to expand their oversight programmes to incorporate a diverse pool of providers that do not necessarily conform to standard contracting practices and supplier/buyer influence and leverage norms.

A forward-looking assessment of risk

Investment managers, like many of their counterparts in the broader financial services industry, are working to enhance and identify their management of 'traditional' risks, as well as those that are growing in importance or rapidly emerging. When discussing risk with our investment management clients the key question seems to be: what is the most efficient and effective way to target our risk management efforts?

For investment managers, this is not a race to the top or bottom, but rather to a place where market participants can feel comfortable about the risks they face—so they can concentrate more on growing the business and generating superior returns.

To the **point**:

- In whatever manner a firm is addressing its risk, our survey results indicate that investment managers are elevating the discipline of risk management and are turning to technology and advanced data solutions to increase their effectiveness
- There is still work to be done to both head off emerging risks and address challenges that are inhibiting traditional risk management approaches
- More experienced risk managers are taking the time to examine the nuances of their firm's risk culture by devising new and improved ways to measure risk-taking throughout their organisations and stressing the need for greater organisational awareness and integration across risk, IT, operations, compliance, internal audit and legal functions

When discussing risk with our investment management clients the key question seems to be: what is the most efficient and effective way to target our risk management efforts?

Fair value pricing survey, eleventh edition

Finding the formula that fits

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It goes without saying that there is no precise formula for determining fair value and performing related oversight. Those charged with valuation responsibilities have to do what any scientist in a lab would do: pursue a course of action, measure the results, and then refine the approach, taking into account changes in internal and external factors.

Over the eleven years that we have conducted our annual Fair Value Pricing Survey, we have seen mutual fund firms continue to tweak their valuation efforts in search of the right formula. Along the way, we have catalogued both emerging practices and those that have matured into common industry processes.

Morgan Keegan settlement returns valuation oversight to the spotlight

The omnipresent threat of regulatory action has long hovered over the valuation process—a threat that became real this past year, when one board's oversight formula was publicly challenged. In June, the former mutual fund directors of the Morgan Keegan Funds settled administrative charges brought by the U.S. Securities and Exchange Commission (SEC) regarding their oversight of pricing procedures[1].

The Morgan Keegan case, which came after a series of other SEC enforcement actions, was more than a warning shot—it was the strongest signal yet that the SEC has fund directors firmly in its sights, holding them responsible for fair valuation decisions.

Against the backdrop of the Morgan Keegan case, this year's survey garnered the highest participation since we launched it in 2001: a record 96 mutual fund firms representing more than US$10 trillion in assets under management completed the survey.

1 *http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171574878#.Uih-k9Ksi-0*

A strong indication of how seriously fund boards are treating valuation issues after Morgan Keegan was that survey participants identified the SEC enforcement actions as the most talked about valuation topic among board members outside of regularly scheduled meetings. These discussions, as well as deliberations during regular board meetings, gave directors the opportunity to assess whether they needed to change elements such as the timing and frequency of their oversight, the type and extent of materials being reviewed and the level of delegation provided to others. These efforts have borne fruit, as this year's survey shows that changes have been made to valuation oversight practices:

- 78% of survey participants have modified their valuation policies and procedures over the last year
- 57% of survey participants have enhanced the level of detail in the valuation materials provided to the board
- 54% of survey participants have changed the types of valuation materials provided to the board

Finding the right balance of information can require experimentation. Providing too much detail may make it difficult for board members to identify salient points or important relationships that may be obscured by the volume of data. Providing too little detail, on the other hand, may result in board members being unable to identify the key questions they should be asking.

Whether fund boards decide to make changes to their oversight approach is, in the end, a matter of judgment. That judgment will likely be directly affected by the types of funds and the nature of investments they oversee, perceived valuation risks and external factors that impact fair value decisions.

Apart from SEC enforcement actions, 34% of survey respondents identified trading halts as the second most popular subject prompting discussion among directors outside of regular meetings. Trading disruptions can affect the availability of security prices and, as a consequence, may trigger the need for fair value determinations, particularly when trading halts continue beyond NAV calculation deadlines.

As technology glitches continue to plague securities exchanges, it appears likely that these issues will continue to demand attention from fund directors and management alike.

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Balancing risk with efficiency

The survey findings show that risk management remains an integral part of the valuation alchemy for many fund groups. More than half—51%—of survey participants indicated that they had identified valuation risks for one or more specific investment types as part of their annual compliance reviews under rule 38a-1 or a formal risk assessment process.

Almost six out of seven respondents (84%) reported that their fund's chief compliance officer (CCO) has a full-time presence at board meetings when valuation matters were discussed. CCOs were also more actively involved in identifying risks associated with the valuation of investment classes. In addition, 58% of adviser compliance personnel also saw their full-time participation at such meetings increase.

There is also an indication that some fund groups adjust the timing, nature and extent of their processes and internal controls based on the type of investment or macroeconomic data. For example, certain funds refine how they identify investment valuations requiring further scrutiny by customising their procedures based on the presence of market-related events, such as movements in an underlying benchmark or changes in credit quality. This approach can be an efficient way to increase effectiveness because it allows fund groups to focus on instances that may be more susceptible to valuation risk, rather than relying on standardised triggers that apply broadly across the asset class.

Given the current business and regulatory environment, a thoughtful assessment of valuation risks allows fund groups to balance both effectiveness and efficiency. In this regard, 38% of survey participants indicated that they had conducted an analysis in the last year designed to identify ways to improve the efficiency of the valuation process and to reduce redundancies. More than 60% of these same survey participants increased automation in their valuation processes in the current year, suggesting there may indeed be a way to rethink the formula for processes and controls to generate better results overall.

Looking ahead

We asked our survey participants to identify what they believe will be the most pressing valuation challenges over the next one to two years. Not surprisingly, navigating the future actions, guidance and expectations of the SEC was at the top of the list for many survey participants. There was a wide range of responses, but the most common are grouped below into these five areas:

1. **Changes necessitated by SEC regulatory action**
   Challenges in the regulatory arena include the uncertainties associated with the SEC's next action, including what it will say (e.g. how prescriptive its guidance or admonitions may be) and how it will say it (e.g. in an SEC speech, another enforcement action, or more formally through proposed industry-wide guidance). Given the complexities associated with valuations and the different practices followed within the industry, it will be important for the industry to continue to share its experiences and perspective in advance of any final SEC action.

2. **Pricing vendor oversight**
   Pricing vendors continue to offer new asset class valuation products, as well as new tools to assist the industry in fulfilling its valuation responsibilities. This year, survey responses indicated an increased focus on transparency tools and how best to use them. These transparency tools can provide meaningful assistance to fund groups in determining whether to make price challenges and in aiding the overall understanding and assessment of a pricing vendor. With these potential benefits also come challenges, such as evaluating how frequently and formally to employ such tools and what steps funds to take in the valuation process when presented with evidence that contradicts the primary valuation.

3. **Managing the external audit process**
   It can be difficult for fund groups to understand current external audit requirements and expectations for valuation testing. Gaining a full understanding of the external auditor's procedures as well as flexibility in handling new audit requests that arise because of changing requirements and expectations is important. Fund boards also need to ensure that they understand the benefits and limitations of the external audit in connection with their valuation responsibilities.

4. **Derivative valuations**
   New asset classes have always created a degree of valuation risk. Derivatives are certainly no exception. Exchange-traded derivatives have historically been more straightforward from a valuation process, but the move to centrally cleared swaps has created a new dynamic for fund groups, Understanding trading volume levels will likely be a factor in determining whether exchange-traded prices are reflective of fair value.

   Over-the-counter derivatives can be a concern for fund groups when the instruments involve underlying securities that themselves are difficult to price. Accordingly, it remains very important for fund groups to truly understand the terms of the contracts and the inputs that are likely to affect the valuation. Fund groups holding more complicated derivatives may want to assess the benefit of having the necessary modelling skills in-house to value these instruments should markets and the environment change.

5. **Board reporting and oversight**
   Even though we've seen industry practices coalesce in certain areas over the years, the governance and oversight structure that will function best very much depends on the particular circumstances of the fund group, and even to some extent, individual board members. Arriving at the appropriate mix of information, degree of director involvement and overall delegation model can be driven largely by the size of the fund group and board, type and complexity of investments and external factors impacting valuation risks. Changes resulting in greater oversight may be called for from time to time and yield beneficial results. That said, boards and fund management should not shy away from discontinuing practices that are no longer effective. As with other areas, sustainability is a critical ingredient for success in the governance and oversight arena, even when the regulator's spotlight turns up the heat.

   Finding the right formula to address these and other challenges will require further exploration in the years ahead. The key will be anticipating and planning for future challenges, including building infrastructure that is adaptable and flexible enough to address developments as they unfold.

Conclusion

This year's survey illustrates once more that valuation practices and processes are continually being refined in ways large and small. After all, valuation is an ongoing and iterative process—even when a fund finds the formula that fits its investment setting and other factors, conditions can and often do change. Over the years, we have seen our survey respondents adjust to these changes and we suspect that they will continue to do so, particularly as the SEC steps up its focus.

To the **point**:

- SEC enforcement actions have led to mutual funds stepping up their focus on fair value
- Mutual fund boards are being challenged to re-think their involvement in the valuation process at all levels and stages
- Mutual funds continue to make refinements as the range and complexity of investment types expand and new investment valuation tools expand

Competition, consolidation and change: key considerations in European securities clearance

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Competition in securities trading and clearing, the introduction of new trading venues and CCPs, and the repositioning of some market participants continue to fundamentally reshape the securities markets. The accelerated change driven by regulation (including EMIR and MiFID) continues to affect banks, broker dealers and clearers.

Five topics emerge as key considerations:

1. CCP Clearing fees
2. Interoperability
3. The future for equity CCPs
4. Segregation and portability
5. Central clearing for OTC cash instruments

What is behind today's CCP clearance fees and can they be sustained?

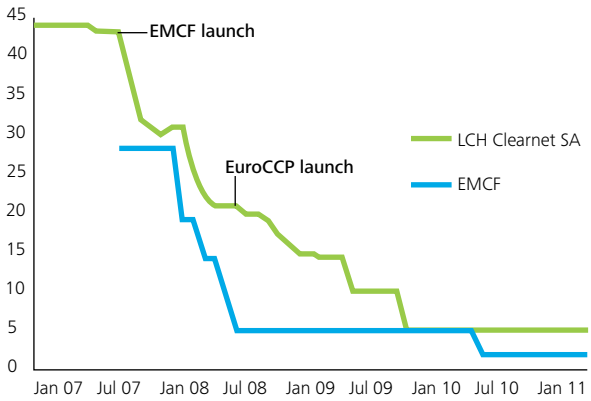
CCP clearing fees have decreased dramatically during the last few years, due primarily to regulatory-driven competition and interoperability:

- Starting in 2007, MiFID I spurred the creation of new trading venues and central counterparties in Europe. These new venues challenged the often national, near-monopolies traditionally held by stock exchanges and CCPs.
- Pan-European Multilateral Trading Facilities (MTFs) such as Chi-X, BATS Europe and Turquoise attracted the necessary liquidity for their markets by competing with the traditional exchanges on speed of trade execution and the cost of trading and clearing.
- Prior to the introduction of interoperability, a trading venue could only enter into an exclusive relationship with a single CCP. Here too, newly created CCPs such as EMCF and EuroCCP changed the rules through lower price models. These models were another important contributor to attracting trading liquidity to the new MTFs. The new MTFs and CCPs were symbiotic partners and as their combination attracted a greater market share, the traditional CCPs lowered their own clearing fees.

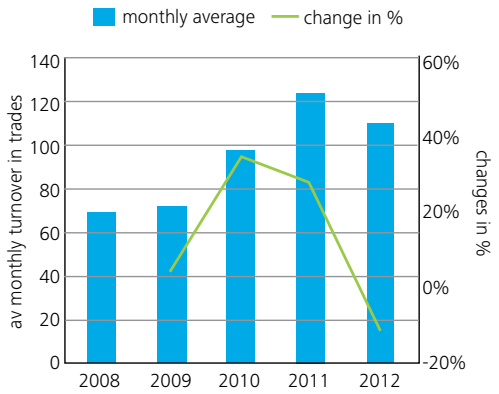
Competition increased when broad interoperability was introduced in Europe in 2012, driving CCP clearing fees further down as increased transparency caused these fees to become an even more direct instrument to attract business for CCPs. In fact, CCP clearing fees reached their lowest levels at the end of 2011 in anticipation of interoperability in early 2012.

Currently, the lowest CCP clearing fees in Europe are nearly comparable with those in the U.S. While that is largely viewed by market participants as a positive, there is another side to the story.

6 Year Decrease in Clearing Fees on European Equity Clearing CCPs vs. European equity Trading Volumes



LCH Clearnet SA fees represent the average clearing fee trend
Source: EMCF, LCH Clearnet SA, Spring Associates analysis



Today's low clearing fees are putting the profitability of equity-only CCPs under considerable pressure. Many CCPs today charge for auxiliary services (e.g. account maintenance and collateral handling) and may apply cross-product subsidies such that cash equity clearing is subsidised by derivatives clearing, if available.

So the question has to be asked: is this a sustainable business model for Europe's equity CCPs? Participants may well expect to see clearing fees fall further but it remains to be seen whether CCPs are able to reduce fees further without compromising the economics of their business model. One school of thought holds that clearing fees are more likely to increase; however, this would be a difficult commercial decision for CCPs, particularly those actively competing for interoperable trade flows.

If CCPs are unable to raise fees, the following options are available to them in order to maintain a healthy business:

- Lower costs
- Introduce new markets, products or services (for new sources of income)
- Find partners (mergers or take-overs)

We expect that most CCPs will be considering all three options, either separately or in combination with each other.

Many CCPs today charge for auxiliary services (e.g. account maintenance and collateral handling) and may apply cross-product subsidies such that cash equity clearing is subsidised by derivatives clearing, if available

Interoperability: will we see additional progress or adoption?

As a first step in ending exclusivity in the relationships between trading venues and CCPs, broad interoperability was implemented amongst a very limited number of trading venues and four European CCPs in January 2012.

Interoperability is an operational and legal arrangement between CCPs that enables clearers to consolidate transactions executed on multiple trading venues with their CCP of choice and therefore to optimise margin requirements for their trading members and bring further cost efficiencies. In theory, a clearer will only have one CCP relationship to maintain, one net settlement per ISIN, one consolidated margin requirement and collateral pool, and a single contribution to a default fund. Unfortunately, eighteen months after broad interoperability was first introduced, this ideal state is still largely aspirational.

For broad interoperability to succeed, more CCPs must subscribe to the operational and legal arrangements, and more trading venues must be willing to share their trade feed with multiple CCPs. Most venues have not met this goal; in fact, thus far the major regulated stock exchanges in Europe have not participated in any significant way, as embracing interoperability may impact their turnover and liquidity. Involvement by the major stock exchanges will be essential to achieving the expected benefits of interoperability.

The best way to push interoperability ahead is for members to put pressure on the trading venues on which they trade. The members bear today's high costs and will ultimately benefit from consolidation. The current restricted implementation of interoperability keeps costs higher than would otherwise be necessary.

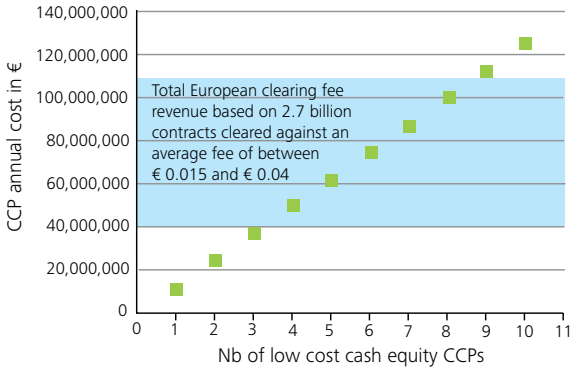
What does the future hold for cash equity CCPs?

Given lower clearing fees and limited interoperability, simple mathematics suggests that, using current pricing models, there are not enough cash equity transactions to be cleared to sustain the 15 cash equity CCPs currently active in Europe.

The graph on the right is based on 2012 statistics from the Federation of European Securities Exchanges (FESE). The light blue area covers the total equity clearing fee revenue for 2012 if all CCPs had charged competitive clearing fees. A low cost CCP will have an annual cost base upward of €12.5 million. This means that the total European volume can support no more than eight low-cost cash equity CCPs. Currently there are approximately 15 of those CCPs in Europe and they do not all operate on the same low-cost basis.

EMIR, or the European Market Infrastructure Regulation, is also forcing many CCPs to review (and perhaps reconsider) their business model. EMIR has introduced detailed rules and regulations for CCPs, including organisational requirements, risk mitigation measures and specified capital requirements. Under EMIR, all CCPs need to (re-)apply to the regulatory authorities for a formal European 'license to clear' by 15 September 2013. CCPs who cannot or will not want to comply with some of the new rules may exit cash clearing altogether.

Consequently, we expect to see additional CCP consolidation, whether through mergers, take-overs or other forms of cooperation. A recent example of this is the take-over of Oslo Clearing by Swiss based SIX X-Clear and, more recently, the announced merger between EuroCCP and EMCF.



What are the options for segregation and portability?

EMIR Article 39 directly affects securities clearance through requirements for segregation and portability. To summarise, clearers must offer their trading members the option to have their positions and collateral administered in segregated accounts (held separate from other trading members' positions and the clearer's proprietary positions). This will most likely become mandatory in the first quarter of 2014. Segregation in this respect must be upheld in the books of the clearer, and must also be maintained at the CCP. Segregation is intended to protect the trading member against the default of its clearer. Should a clearer default, the trading member's positions and associated collateral can easily be identified and transferred to a new clearer (portability). Therefore, the strength of the clearer becomes a critical factor in determining the need for segregation.

While the aim of building more client protection into the complex system of relations between the relevant market participants is commendable, this protection comes at a cost.

- CCPs must implement the new segregation protocols for positions and collateral. This will have significant technical, operational and legal implications. As a new service, it will most likely involve a new fee charged by the CCPs (some of which have already been published).
- Clearers will not only have to offer segregation—resulting in technology and operational changes—but will also need to demonstrate in legal terms to trading members that segregation offers the desired level of legal protection. Trading members who make use of this new service may also be charged a fee by their clearer for this.

Ultimately, market participants who are not self-clearing will have two choices:

1. Opt to segregate their positions and collateral at the clearer and CCP level and incur the extra costs, or
2. Opt to clear with a strong, stable and secure clearer whereby the extra layer of segregation and cost will not be necessary

Therefore, the strength of the clearer becomes a critical factor in determining the need for segregation

Will we see mandatory OTC securities clearing?

The shift to central reporting through trade repositories and clearing of OTC derivatives formalised in EMIR is intended to mitigate risk by increasing transparency into outstanding rights and obligations. Many market participants have asked the obvious: why shouldn't the same logic apply to OTC cash securities transactions?

The answer is provided in the MiFID proposals which indicate that clearing obligations for OTC cash securities transactions (equities and bonds) are likely to be adopted in some form at a future date (MiFID II, Level 1, Proposed Article 16.A).

In practice, however, OTC cash securities transactions can now be cleared centrally. The largest European CCPs already accept OTC transactions for clearing and settlement.

These services are not yet widely used since the CCPs require matched trade instructions in a specific format. To centrally clear an OTC transaction, for example, both the buyer and the seller have to register their side of the transaction with a so-called 'matching engine provider'. These service providers will then pass on the matched trades in the correct format to the CCP for further processing. These extra steps and relationships impose additional costs and the number of providers is limited. Additionally, should a trading member elect to centrally clear OTC cash transactions, the CCPs would require extra collateral to cover the margin requirements calculated for those positions, increasing the cost further. Nonetheless, market participants should keep in mind that, ultimately, a large part of OTC securities transactions are likely to be routed through a CCP in the coming years.

Market and institutional impact: conclusions

As a market leader in global clearance, J.P. Morgan works closely with trading members and market infrastructure groups to identify and assess the impact of ongoing market changes. We believe that clearers have an important role in providing trading members with up to date (as real time as possible) and transparent insight into their intraday credit and collateral requirements. They should work closely with trading members and infrastructure providers to support current and emerging business needs as the new global securities clearance model continues to take shape.

To the **point**:

- CCP clearing fees have reached their lowest levels for the time being. CCP focus for the coming year will be on consolidating the existing business and investing in new ones
- Interoperability has come to a stand-off between the large exchanges in Europe. Only the trading community can move things in the right direction, i.e. more trading venues participating
- There will be fewer, but highly regulated and strictly supervised, equity CCPs in Europe
- Segregation and portability will offer new protection to non-self clearing entities but will also raise costs. Alternatively, a strong and reliable partner can be chosen as a clearer
- OTC securities clearing will become commonplace within a few years

Who wants to collect millions?

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With more than 3,200 management companies in Europe and at least 55,000 funds (EFAMA—June 2013), places in the sun come at a great cost for those who want to collect millions. Domestic markets have become too narrow and local investors, whether private or institutional, are no longer able to support asset management players.

In France—the second largest collective management market in Europe (behind the UK)—the lacklustre collection (historical outflow phase that began in 2007) is the result of various factors:

- Cultural risk aversion (-40% of individual shareholders from December 2008 to September 2012. Source: TNS Sofres)
- Institutional investors seeking a credit balance position (in 2012, -22% decrease in the volume of calls for tenders to select asset managers. Source: BFinance)
- Competition in terms of regulated savings (€49.2 billion invested in the Livret A and LDD in 2012, compared to €17.5 billion in 2011 and €5.6 billion in 2010. Sources: FFSA, Caisse des Dépôts, Banque de France, Eurostat)

In this context, where few forward-looking indicators are positive, the only alternative is to turn to export. However, the sale of products abroad by management SMEs is not as easy as it looks. Some of the obstacles for management companies will be the learning curve (owing to the length of the learning phase), tailoring of the offer to the expectations of international targets and adapting sales teams and support services.

Together with the substantial investment required to win new customers, optimising all processes and streamlining expertise are key to securing margins. One of the paths that may be followed in connection with these objectives would be to streamline the organisational system of existing management group structures in Europe.

Currently, a firm comprises a set of local subsidiaries that are authorised to conduct the primary management activity on their domestic market, and single entities (without authorisation) whose purpose is to promote sales.

Current regulatory measures now facilitate the set-up of cross-border structures:

- Since the UCITS IV directive came into force in July 2011, the introduction of a management company passport has enabled authorised management companies in a member state to act as management companies of UCITS in another member state.
  The management company passport allows asset managers greater flexibility with regard to the place of domiciliation and administration for their funds.
- During the entry into force of the AIFM directive in July 2013, an intra-European passport was set-up for European managers in charge of European AIFs. This passport will authorise any AIFM in charge of AIFs to sell the funds that it manages to professional investors in Europe, in return for authorisation from the relevant European authority.

Revamping an organisation requires thought as to what are its priorities (collection and/or efficiency), while taking into account the firm's current set-up and its background (organisation, international presence, type of expertise and products, type of clients, etc.).

However, at least five critical aspects must be taken into account in this utopian table:

- Location of the structure
- Management of human resources
- Implementation trajectory
- Tax implications
- Management of delegations

PHASE	ALTERNATIVES	RELATED ISSUES
Regulatory	A single portfolio management company with all the authorisations or several regulated structures	Level of relationship with the supervisory authority and qualification of the substance
Vehicles	Selling restricted to Europe or worldwide	Appeal/positioning Vehicle size Loan transfer strategy Sales agreement (between the supervisory authorities and the distribution country)
Management centers	Location of expertise based on the current set-up (or ability to find experienced resources), organisation of delegations	Adaptation of expertise to expectations, transfer pricing management
Central administration	Detailed breakdown of functions, concentration (Hub) and optimisation of process fluidity	Management of resources, Automation, role synergy
Sales teams	Proximity of collection points or concentration of sales teams, support of an operational marketing department and centralised client services, management using dedicated and interfacing tools (CRM), loyalty and prospection system	Phased management of client/channel penetrations

RISK MANAGEMENT

OPTIMISATION MANAGEMENT

The 'Universal ManCo' model (see Performance 2013 article) is now the subject of in-depth study. The creation of a regulatory holding company naturally generates substantial economies of scale compared to locally regulated management structures.

Illustration of an organisation for a management firm with locally regulated management structures

Universal ManCo

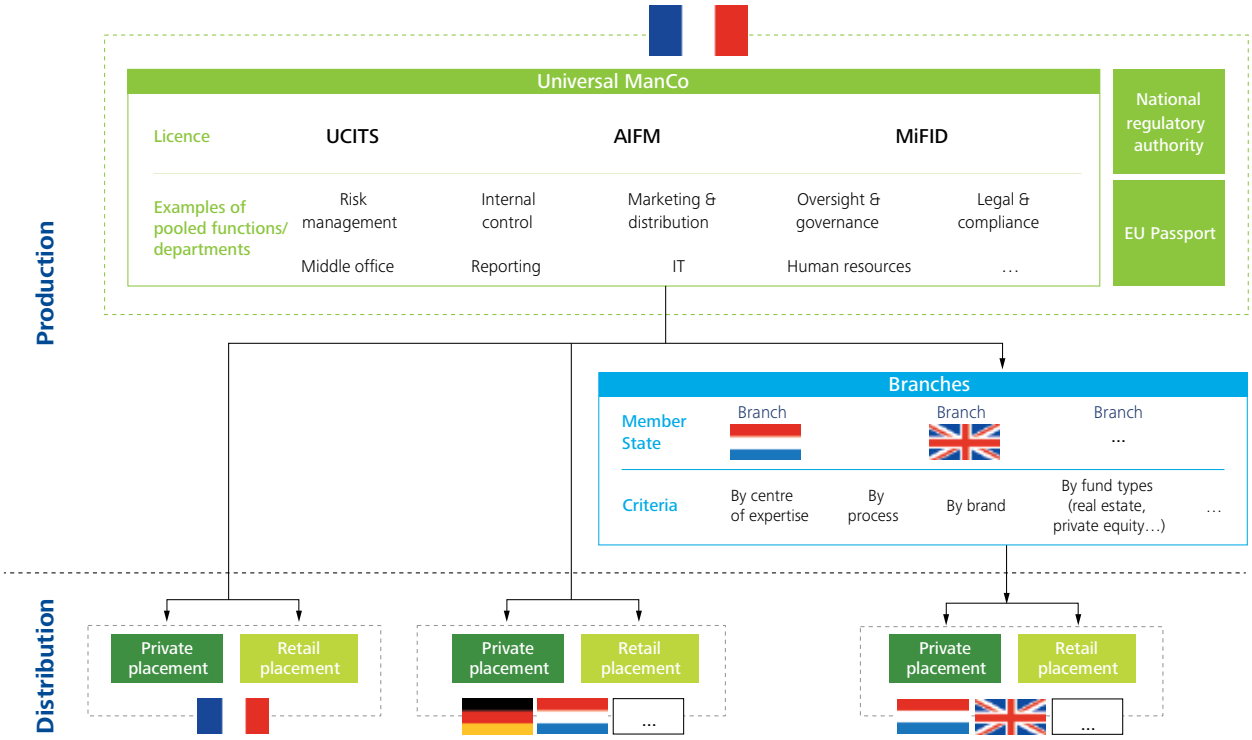
Advantages

- A single structure: relationship with a single supervisory authority
- Single contact point for service providers and investors
- Legal and compliance simplification
- Centralisation of process and control resources
- Generation of synergies

Disadvantages

- Pooling of dissimilar activities or functions
- System that must comply with the strictest regulation

Illustration of a 'Universal ManCo' model covering all group licenses



Compensation plans, individual tax status, different living standards, and infrastructures among other aspects, should be included in the selection criteria matrix

Location of the structure

The implementation of the ManCo model is a genuine regulatory, organisational and fiscal challenge. The characteristics and sensitivity of a supervisory authority vary from one country to another.

Certain authorities are considered as business friendly with a pragmatic treatment of requests from portfolio management companies, whereas others demonstrate vigilance at all times in order to protect investors. The responsiveness and experience of the counterparties are also critical components. The monitoring system and sanction policy should not be underestimated when it comes to making a choice.

The interpretations of the definition of substance and the proportionality rule may be clearly expressed in a circular, or fall within the jurisdiction of the counterparties or case-law. Finally, a fiscal union has not been established and discrepancies (prior to negotiations with the tax authorities) are apparent for both direct and indirect taxation. Country ratings are also to be considered given their impact on the ratings of local custodians.

Management of human resources

Three points are to be taken into account: mobility, ability to recruit, appeal of the target country. The absence of mobility for key individuals and the difficulties in identifying local resources for management, risk, and middle office represent hidden obstacles when looking for a foreign place of establishment.

Compensation plans, individual tax status, different living standards, and infrastructures among other aspects, should be included in the selection criteria matrix.

Implementation trajectory

Removing the substance of a regulated entity or transforming this structure into a financial service provider needs to be handled with the greatest of care. The adoption of a Universal ManCo approach results in a transition during which the various regulated structures will co-exist pending the standardised operation of the target entity.

Tax implications

When setting up abroad, certain countries have a tax ruling process that commits the tax authorities to the early consideration of transactions that have repercussions for the level of taxation. Moreover, certain countries have not adopted the financial transaction tax process.

Management of delegations

The possibilities of delegating the primary activities can be analysed with regard to the definition/interpretation of the substance ('letter-box' notion).
There are two variants:

- A quantitative vision (weight of delegated activities < weight of non-delegated activities)
- A qualitative vision (delegation possible if able to carry out controls).

Another factor to be considered is the service provider's status and location which, in certain transpositions and for certain activities, must have a specific authorisation. Transfer prices will have to be determined taking into account the practices of the local tax authorities (whether or not the 'arm's length principle' is applied).

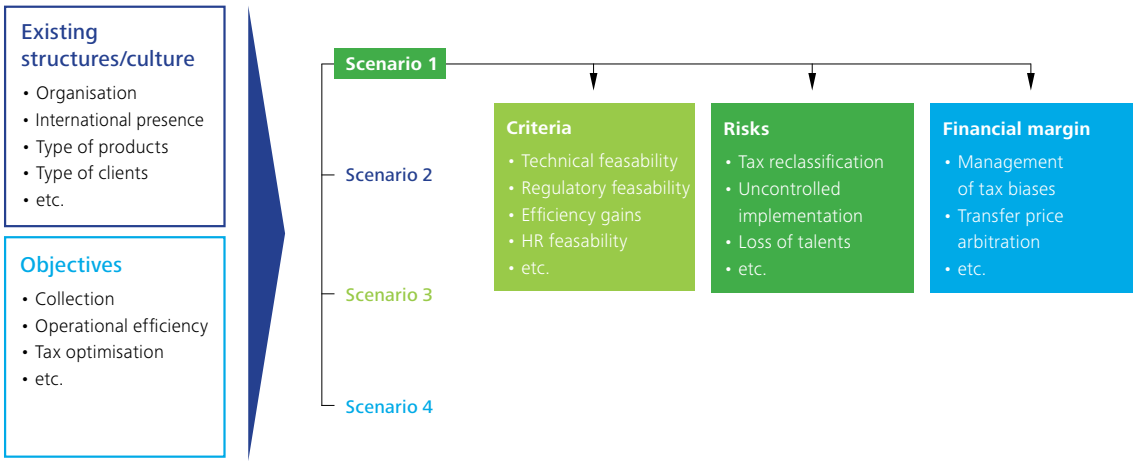
In addition to fund structuring decisions, the Universal ManCo requires careful consideration from an operational point of view. Asset managers must thoroughly examine a range of aspects including overall administrative organisation as well as local practices in the chosen domicile.

We see two cases commonly emerging. The most common scenario relates to large asset managers who choose to centralise multiple structures under one Universal ManCo in order to rationalise their operations and comply with AIFMD. The attention of small to medium-sized firms and non-European asset managers, meanwhile, is focused on selecting a management company domicile for distribution in Europe. Asset managers stand to gain in terms of operational efficiency, as the Universal ManCo service model entails the consolidation of information in a centralised structure.

From an operational perspective, the asset manager will require light local infrastructure and a robust global architecture. Among the challenges they must come to terms with are:

- Reinforcing distribution services across Europe and beyond European borders. This requires registration in new distribution domiciles and the development of related reporting and efficient fund registration processes
- Adapting governance, which can involve fund hosting services and consolidated risk monitoring across various countries
- Reviewing the operational model. This entails examining the middle office to back office value chain and how it will be influenced by the new local/global service model

Finally, the range of asset classes and fund structures that are managed—whether they are UCITS products, retail funds and private equity or structured products—will clearly influence the approach and the operational solution chosen. On the whole, streamlining a firm's management structures requires a set of multiple and differing parameters to be taken into account according to a structured yet recurring approach. The potential economies and synergies are clearly evident, but the path to reach the target does not appear entirely straightforward.



The attention of small to medium-sized firms and non-European asset managers, meanwhile, is focused on selecting a management company domicile for distribution in Europe

To the **point**:

- Extending the application of the European passport to all collective investment products gives pause for thought regarding the operating systems of European management companies
- The model is of particular interest to management entities with multiple locations in Europe, as well as non-European establishments that wish to obtain a European license for their management activities
- Implementation of the Universal ManCo model requires a detailed analysis of the critical issues (location of the entity, human resources management, implementation process, tax implications, delegation management, etc.)
- The Universal ManCo model meets operating efficiency objectives

Digital:
a potential source of differentiation and/or an effective addition to distribution channels?

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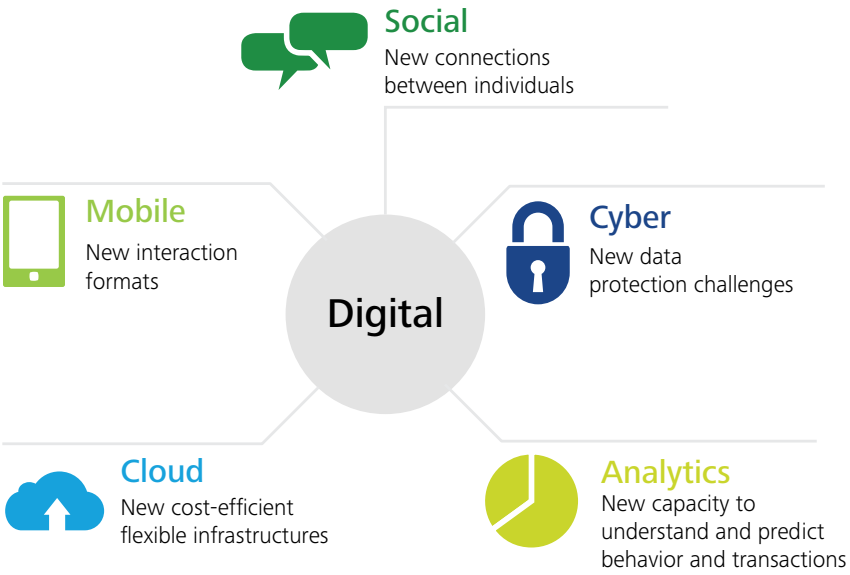
In a context of technological innovations and cultural change, asset managers (AMs) are currently facing a digital revolution.

The digital environment and challenges of the Asset Management industry:

- Gaining new market share and limiting the erosion of existing market share **(moving from a product-based strategy towards a client-based strategy)**. Using new communication and distribution channels to target a wider client base (establishing an **international position**), **at a lower cost**.
- Developing **brand image, reputation and leadership** based on expertise through new digital media. In a competitive environment, asset managers are seeking to stand out by developing their reputation and leadership (in order to **clearly position** themselves in a fragmented market).
- Seeking to develop **responsive production methods** in order to promote innovation (and not only product innovation), while keeping costs under control. The rationalisation of product offerings, optimisation of existing organisational structures and **innovation**, are the key success factors in this sector.



We conducted a study of the main international players and analysed their digital strategies.

Digital media and analysis indicators:

Indicator	Website	Mobile terminals	External social networks	Expert networks
Content	✓			✓
Functionalities	✓	✓	✓	✓
Dynamic nature of content	✓	✓		✓
Accessibility	✓	✓		✓
Graphics/ User-friendlines	✓	✓	✓	✓
Followers			✓	
Social Authority			✓	
Tweets/day			✓	
Subscriptions			✓	
Community interaction			✓	
Who is talking about this			✓	

Main observations of the study:

While the use of websites has already attained a certain level of maturity, results have shown more marked differences for other digital media, particularly with respect to the use of social networks, which are significantly more developed within international asset management players. The dynamism of content communicated and the interactivity of communities are the main quantifiable performance indicators for these media.

With regard to mobile applications, we observe that across the population of international AM players analysed, some 40% have not yet offered mobile, smartphone or tablet solutions to their clients.

Expert networks, or blogs, are under-utilised despite the uncontested advantages they offer, particularly for the regular publication of analyses and market convictions, often relayed by management company social networks, improving brand visibility.

The dynamism of content communicated and the interactivity of communities are the main quantifiable performance indicators for these media

Websites

The internet, a tool adopted and developed by all
The majority of asset managers have high-performing websites providing clients and prospective clients with rapid access to information: presentation of the company and the product range, access to regulatory documentation (reports, prospectuses, KIIDs, etc.), publications and market convictions. Certain asset managers offer clients tailored functionalities when logged in to a personal account.

The performance of a website is based on a combination of several criteria and particularly the use of innovative tools and a fluid and intuitive navigation experience

The best players stand out by providing access to straight-forward information, clear content, good-quality and dynamic graphics as well as innovative functionalities. This includes online investment portfolio modelling tools with investment objectives, such as those offered by Black Rock.

Mobile terminals (Smartphones and tablets)

Mobile applications allow AMs to expand the scope of services offered to private individual and institutional clients through a wide range of functionalities, greater accessibility and more regular updates of available information.

The highest rated management companies propose a comprehensive and innovative service offering, improving the autonomy of their clients. Smartphone and tablet applications provide access to all group funds, financial news, publications, podcasts and manager viewpoints. The application must also provide access to all of the group's digital media, such as social networks and expert blogs, as is the case with the Franklin Templeton tablet application.

Tablet applications also help strengthen brand image, by using innovative functionalities and visual effects, vectors of the management company key messages and values.

External social networks

Social networks are a new channel for communicating and sharing with clients, prospective clients and partners. They provide an alternative/complementary format to traditional communication and enable a more direct relationship to be forged in an environment conducive to exchanges. However, while social networks are a new source of opportunity, they also represent an organisational and regulatory challenge that must be met by management companies.

Our analysis showed that the most mature players on social networks and the best organised in managing communities have become true opinion leaders. They have successfully created a sharing relationship with their community and introduced an effective 'listening' and communication tool (direct exchanges, gathering of opinions and reactions).

We also observed that the quality and relevance of the information exchanged improves when discussions target a specific population (e.g. retail clients, institutional clients or partners). Vanguard and JP Morgan AM UK have Twitter accounts for financial advisers which they use to share information that will help them understand the economic environment and the strategies proposed and thereby strengthen their commercial approach.

While we observed that certain players fully exploit the potential offered by social networks, using them to create ties with clients/prospective clients, and as a community 'listening' tool, the majority of management companies still use them as an additional means of pushing information. The main challenge will be to create strong interaction with their communities to enable a more effective use of social networks.

If management companies are to master social networks they must effectively facilitate their communities. Facilitation must be centralised and performed in close conjunction with marketing, legal and compliance teams to control the quality of information communicated and its consistency with the communication strategy.

Expert networks

Expert networks seek to increase awareness of asset managers by presenting their market convictions, in order to be followed and shared on social networks.

Extremely regular publications via blogs or mini-sites enabling players to present their convictions:
Numerous asset managers have chosen to distinguish themselves by regularly communicating market expertise via a mini-site or more commonly a blog. Analyses are based on the convictions of management company players and are publicly available.

Market convictions are relayed on social networks:
The added value of these expert networks is that they offer independence while presenting an assumed market viewpoint. The aim is to encourage exchange (ability to leave comments) and sharing on social networks. Certain players, such as Franklin Templeton, have opted to highlight the expertise of an opinion leader, very often relayed on social networks, providing increased brand visibility.

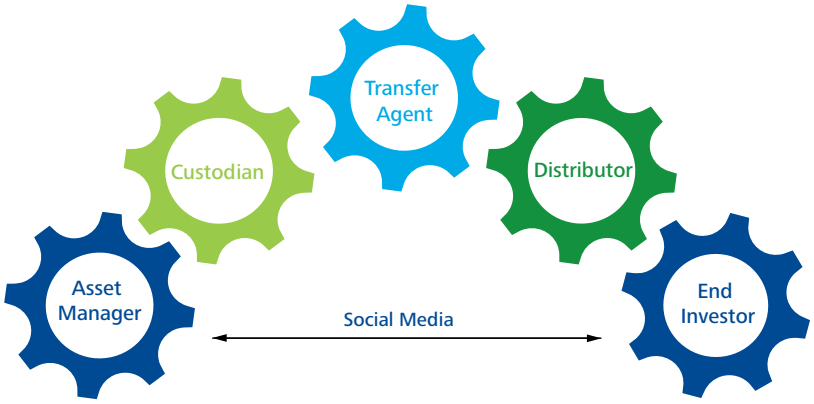
The performance of a website is based on a combination of several criteria and particularly the use of innovative tools and a fluid and intuitive navigation experience

Some digital contributions / solutions to asset management issues

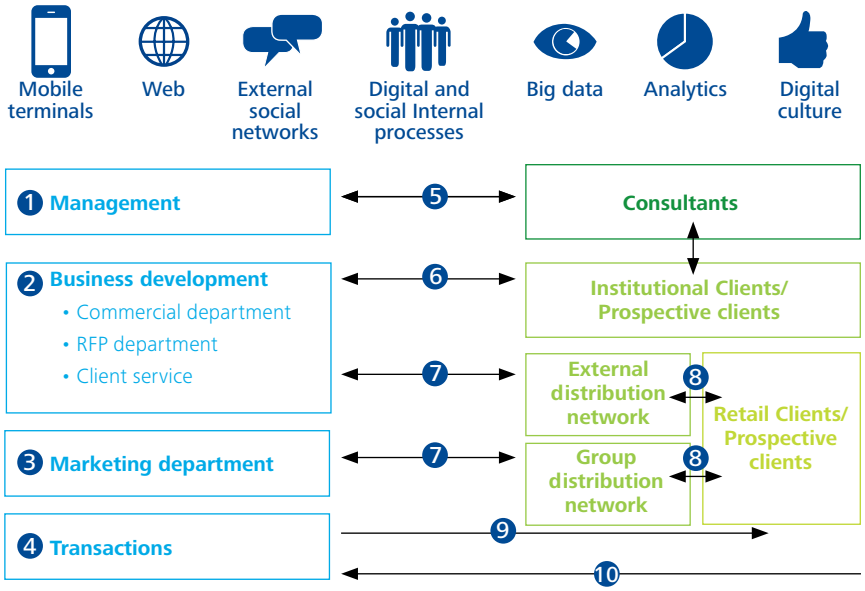
- Given the complex flow of transactions, it is virtually impossible for asset managers to establish direct contact with the end investor. The trend towards outsourcing an increasing number of functions has intensified this problem. The fact that social media can serve as a direct communication channel and thus improve mutual understanding is one of the key advantages of using social media in the fund industry.
- In the asset management company environment, digital solutions[2] can be implemented in response to specific business needs.
- 'Socialise' the internal management of client relations

In addition to using external social networks, 'social' technologies could be integrated into CRM systems to improve internal CRM processes.

Traditional Value Chain vs Social media Communication



Digital answers to specific AM issues



2 *Digital solutions 1 to 10 in the graphic*

We have identified the following gains achieved through the **'socialisation'** of processes:

Knowledge management

- Easier exchange of information across all axes (i.e. vertically and horizontally)
- Strengthens expertise by facilitating the sharing of best practice
- Development of collaboration by encouraging participation in expert communities
- Limiting of distribution redundancy and centralisation of knowledge while constantly enriching content

Governance

- Accelerated spread of a digital culture within the company
- Increases process fluidity by contributing contextual/conversational information at all stages
- Improved collaboration between the various client relationship players (front and back offices)
- Improved readability and understanding of interactions: acceleration

Steering activity

- Improved monitoring of process execution
- Integration of commercial facilitation through a permanent, real-time exchange with the network
- Opportunities for enriching business indicators with behavioural and qualitative data

Managing talent

- Forging of ties and placing the individual back at the heart of work
- Detection of potential by measuring social/behavioural data
- Addition of mobilisation drivers, such as 'gamification'

In addition to using external social networks, 'social' technologies could be integrated into CRM systems to improve internal CRM processes

The digital transformation

Our recipe for a successful digital transformation:

1. Start with a concrete business objective
2. Have a comprehensive view, as digital strategy transforms all aspects of the asset management company business model
3. Select a pilot project tailored to the digital 'ecology'environment
4. Beyond the pilot project, understand the digital transformation 'dominos'
5. Take account of local social network regulations, while protecting client information, the equality of unitholders and personal data

1 Begin with a concrete business objective without forgetting to address Digital-related risks

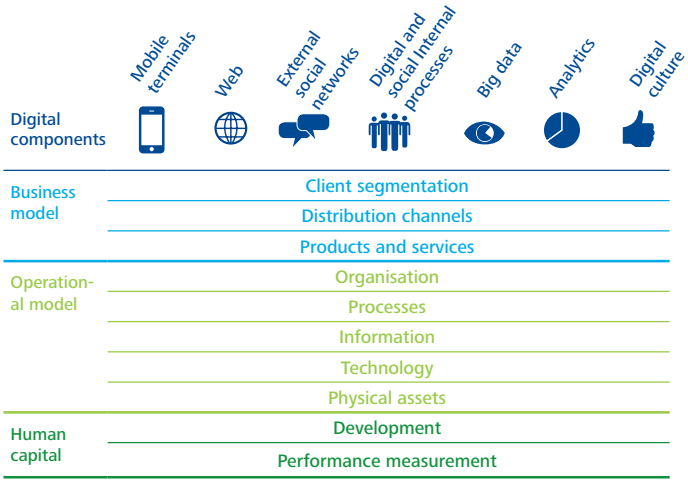
What objectives are targeted through the selected Digitalisation project?

Generate growth	Optimise costs
• Win new clients	• Acquisition costs
• Multi-product/asset classes	• Operating costs
• Retention	• Management/Service costs
• Innovation	

Without forgetting to address digital-related risks

- Reputation risk
- Legal risk
- Risk of not processing information flows

2 Have a comprehensive view, as digital transforms all aspects of the Management company business model



3 Select a pilot project tailored to Digital 'ecology'

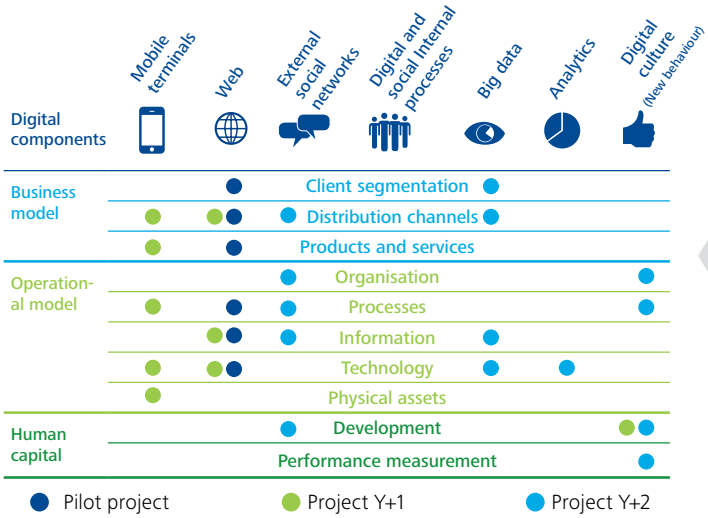
Start small
Start with a reasonable project with rapidly visible benefits

Think big
Have an overview of long-term objectives to guide thinking

Fail fast
The risk of failure is never zero. You must be able to detect it sufficiently early in order to rapidly remedy the situation

Scale soon
The company must be able to capitalise on the benefits generated by the pilot project and replicate identified good practices for the next project

4 Beyond the pilot project, understand the digital transformation 'dominos'



5 Take account of local social network regulations, while protecting 'client information', the equality of unit holders and personal data.

To the point:

In a sector where the key issue is collecting funds and in a context of significant technological innovation, digital media can help asset management companies:

- Develop internationally (collection source)
- Promote the brand by clearly positioning themselves in a fragmented market
- Increase visibility of the different areas of management expertise and develop innovation
- Exchange and communicate differently with clients and prospective clients (client-focused strategy, client value/capital)
- Communicate directly with final clients without passing through standard sales intermediaries (group and external distribution, consultants)
- Work more efficiently within the company by implementing 'social' internal processes ensuring true team work

The various digital components form part of the tools currently available to help expand the visibility of an asset management company's brand and expertise with clients at a low cost.

In this context, asset management companies must adopt a structured approach involving marketing, legal and compliance teams to control the quality of information prior to its dissemination on social networks, as well as to ensure it complies with regulations and is consistent with the asset management company's communication strategy.

Expert networks, or blogs, are under-utilised despite the uncontested advantages they offer, particularly for the regular publication of analyses and market convictions, often relayed by management company social networks, improving brand visibility

The case for social media in the decade ahead

Julien Semonsu
Marketing Director
Franklin Templeton

For an industry in which legal and compliance regulations can complicate even the simplest of public-facing communications, is a responsive social media presence even possible? And is it worth the effort? Franklin Templeton Investments says the answers to both questions are 'yes'.

What's the Big Idea?

Back in 2009, an ambitious member of the Franklin Templeton marketing team wondered: *'what would happen if we took a popular figure and public speaker like Dr. Mark Mobius and gave him a blog? And a Twitter account? Demand for the globe-trotting portfolio manager's emerging market insights and experience had him making media appearances and doing interviews regularly anyway, so why not see what happens when he's given his own platforms?'*
Dr. Mobius enthusiastically embraced the opportunity and, after a great deal of legal and compliance work, he launched his blog, Adventures in Emerging Markets Investing, and his Twitter account, @MarkMobius.

The response was immediate, positive, and wide-ranging. Suddenly, Dr. Mobius had a way to easily share what was on his mind: trends in far flung locales, political bellwethers, regional or sector hotspots.

Those curious about the emerging markets guru's insights could easily access them, day or night, whether they lived in Alabama or Zambia. And, better yet, they could even ask him questions.

Within months, though the legal and compliance issues around financial services' use of social media were relatively uncharted territory, it was evident that there were thousands of people around the globe interested in portfolio manager perspectives on social media.

To capitalise on this growing opportunity, we broadened the firm's social presence, creating a variety of content suited to myriad channels and audiences. This meant thinking through the infrastructure that would support compliant, scalable, and repeatable processes.

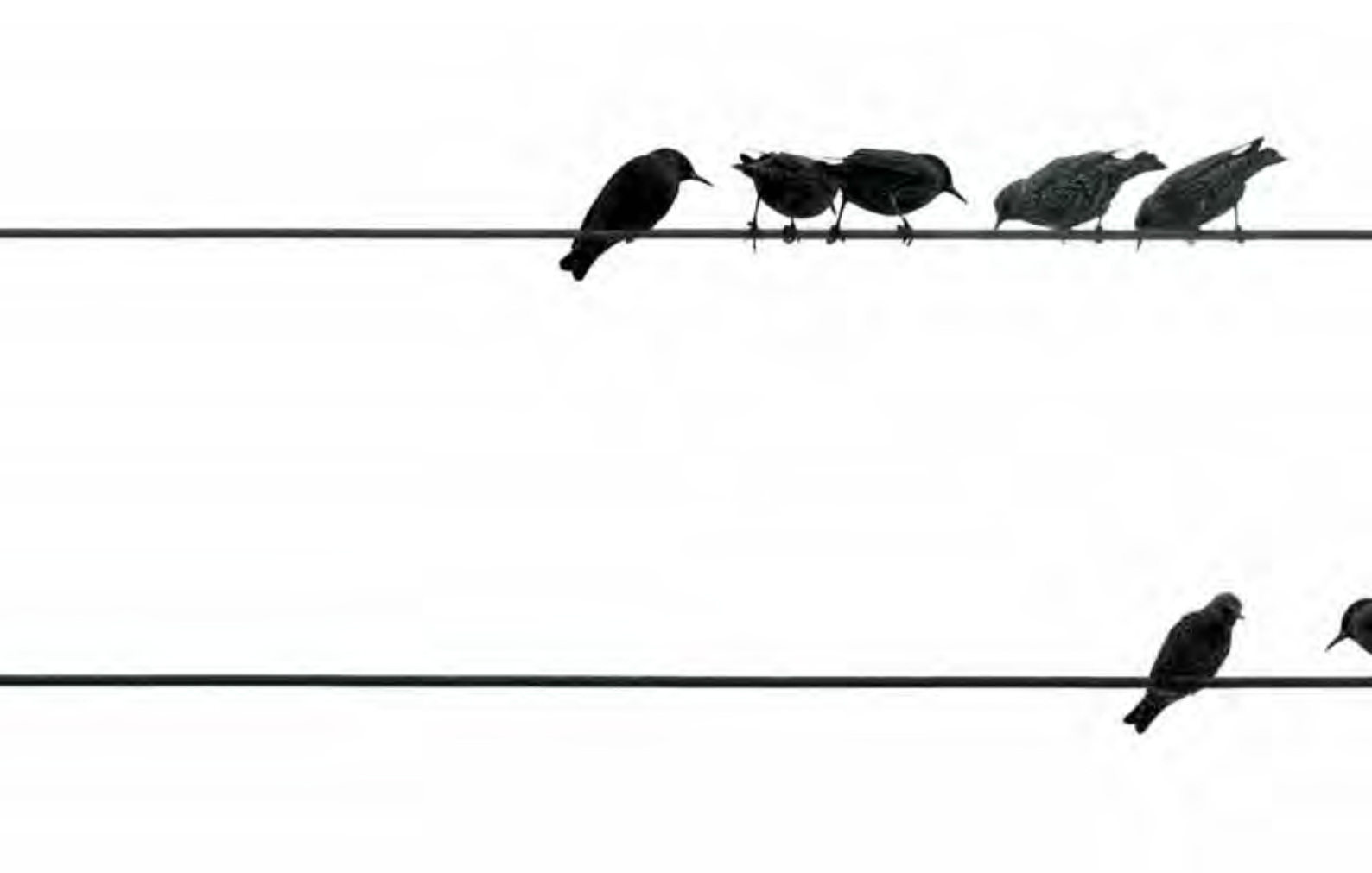
Among the elements we built were:

1. A firm social media policy, which articulates what Franklin Templeton employees can and cannot do on social media channels, and recognises the limits of the firm's control over individuals' non-work related online behaviour.

2. A comments management policy and SLA (Service Level Agreement) procedure document, which identified a global team with clearly delineated responsibility over when they will be 'on watch' for comments or queries that warrant a response, and a set of guidelines about what to respond to and how to respond to it.

3. A set of initial KPIs (Key Performance Indicators) inspired by cross-unit business goals, baseline metrics for measuring our progress towards each of these, and a standardised approach to the language and methodologies related to metrics.

4. A new media committee comprising global marketing, legal and compliance representatives that meets twice per month.



Making it Personal

Relying on purely organic growth at first, these new social channels enjoyed a warm reception. However, in a space where individual or business-to-consumer interactions were natural, the social media relationship between individuals—an uncontrollable mix of advisory clients, end investors, investing enthusiasts, and others—was more challenging to nurture.

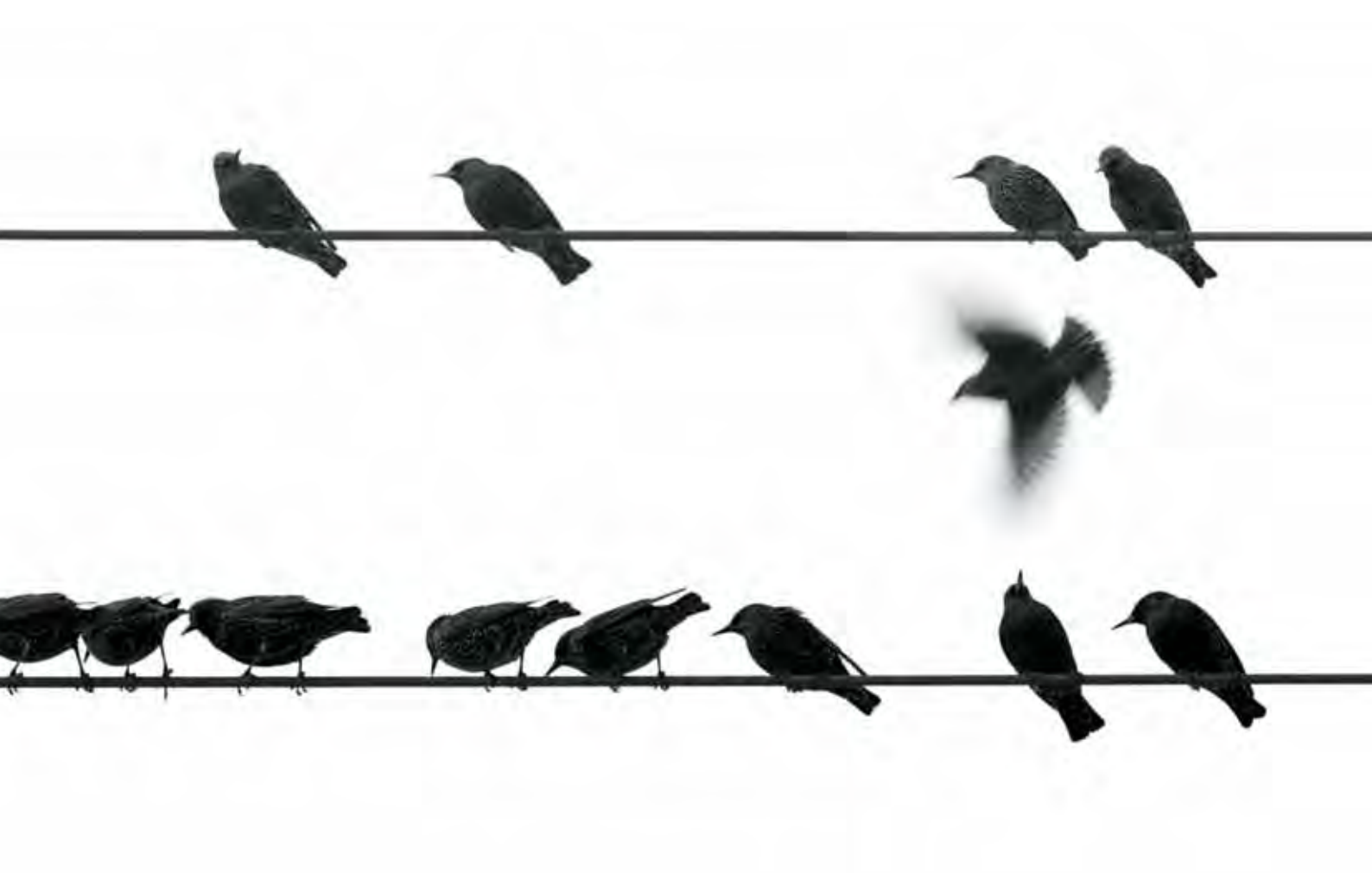
While the ranks of fans slowly grew and they increasingly not only consumed, but shared the corporate-branded content they especially enjoyed, the question became: *how can the firm empower its sales-force to easily, effectively, and compliantly tap into the communications and networking power of social media in order to be where our clients are, engage with them, and make doing business with us as easy as possible?*

Salespeople were meeting with, calling, and emailing their clients and prospective clients on a daily basis. Social media is merely another communication tool, so while the practical and compliance concerns were certainly complicated, they were also manageable.

Presented with the potential to positively impact the sales process and the additional digital reach that could be supported by individual sales personnel through social media channels, the firm was able, in about four months, to resolve technological, process, and content questions around how to support sales-level social media activity.

A key element for us was a web-based software solution designed to support various aspects of a social media programme: compliance, ease of use, and measurement.

With this tool and these processes in place, we were able to supply a diverse global pilot group with separate libraries of social content that were relevant and compliant in their respective local markets. In simpler terms, each new programme participant was suddenly able to maintain an active, visible LinkedIn presence designed to meet the varied needs of his client community in just two clicks.



As Julien Semonsu, Franklin Templeton's Marketing Director Southern Europe/Benelux notes, *"Of course we were interested in leveraging social to maximise the reach of our priority marketing messages, but we knew that if we wanted our clients to engage with us, we had to be responsive to what they wanted to talk about and not just push our own agenda."*

To enhance the potential impact of each post, we worked with each sales person to import his or her existing client list to LinkedIn. We were able to create a process they found to be simple and successful, resulting in immediate increases in the number of clients within their respective communities.

While this sort of automation is ideal, in the early stages we found that one-to-one training and follow up meetings with sales users of social media was vital. It was through these individual training sessions and ongoing check-ins that were able to gain insight into the realities of practical application, allowing us to establish best practices and to improve upon every aspect of the programme in ways with the potential to make a positive impact on the bottom line.

Early results indicating ease of use and effectiveness encouraged adoption and sales users' social media activity generated considerable incremental digital reach as well as creating opportunities to support financial advisers. Based on those successes and the ever expanding corporate social channels, we decided to test the addition of country-specific social media programmes to complement the existing global one.

Within months, though the legal and compliance issues around financial services' use of social media were relatively uncharted territory, it was evident that there were thousands of people around the globe interested in portfolio manager perspectives on social media

Going Global

The first test market we identified was France, which was followed by a pilot programme in Italy a few months later. After extensive preparatory work with the local marketing, legal and compliance teams and their U.S.-based counterparts, we were able to identify the local adaptations required to sustain these new country-specific programmes in Europe. The scope of these social media programmes included:

1. **Individual sales-level use of LinkedIn:**
   Sales personnel signed up to Hearsay Social, connecting their personal LinkedIn accounts to the tool. This enabled them to publish vetted content directly through their LinkedIn profile and to fulfil local compliance process requirements.
2. **Local corporate-level use of LinkedIn:**
   This is about geo-targeting status updates so they are only pushed to the newsfeeds of local followers in France and Italy. This enables us to deliver local-language status updates that include links to locally-approved content.
3. **Local corporate-level use of Twitter:**
   Establishing a French language Twitter channel: @FTI_France and an Italian language channel, @FTI_Italia, both of which enabled local language content delivery and a means to directly target local clients as well as local media and influencers.
4. **Both French Italian-language playlists available on the firm's global YouTube channel:**
   With local video production pipelines that did not warrant stand-alone channels, we opted to reduce administrative effort while still providing a conduit for local-language, locally-approved video content, such as portfolio manager commentary.

> Early results indicating ease of use and effectiveness encouraged adoption and sales users' social media activity generated considerable incremental digital reach as well as creating opportunities to support financial advisers

Facebook was reserved for reconsideration at a later stage, though global trend lines indicate financial advisers are increasingly adopting the platform for business use, and are reporting success in prospecting for new clients there.

In many ways we were able to capitalise on lessons learned with previous efforts, but each market did present unique circumstances and requirements that needed to be addressed.

In France, for example, we discovered that the archiving function of the Hearsay Social tool—which was critical to our compliance processes—created a situation in which French-resident online data was being stored offshore on servers in the U.S. This is allowed, but gaining permission to do so requires a legal application to the government, a process which can add up to three months to your rollout schedule.

France also presented us with an interesting conundrum in that local privacy laws do not allow personal online behaviour to be monitored by an employer, but compliance requirements are such that active monitoring of employee online behaviour is necessary in order to ensure employees are behaving in a compliant fashion.

"Like so much of the social media space, this was uncharted territory that was challenging—but also quite interesting—to explore. In the end we were able to find a balance in which our intensive one-to-one training plus comprehensive archiving of all social activity satisfied both sides of the legal and compliance equation." explains Julien Semonsu.

From both a business and a cultural perspective, both France and Italy used business models unique to their markets. As a result, in addition to having to translate content into their local languages, we also had to learn how to adapt the tonality of centrally-generated content, to increase the amount of locally-driven content, and to adjust our process standards to suit local business models. For example, while in the U.S. salespeople have separate client lists, in Italy clients are serviced by the sales group.

Obviously this had implications when it came to points relating to implementation, such as determining who should connect with which clients on LinkedIn.

The Proof is in the Pudding

Benchmarks specific to the financial services industry were, at first, non-existent, so we did an extensive audit of competitor and client activity across social channels to define goal estimates, and over time were been able to establish a sufficiently deep data pool to indicate true benchmarks.

Fleshing out our view of social programme effectiveness is a proprietary algorithm we developed which enables us to quantify what we refer to as the Minimum Value of Social, a concrete measure of bottom line impact based on proxy values.

Internal adoption represents the foundational success metric, since without adoption there can be no other successes. We made participation in the individual sales user portion of the programmes entirely voluntary, knowing that only people who are independently interested in taking advantage of social media for business would have the enthusiasm needed to adopt new workflows and the fortitude to endure the inevitable technological hiccups.

We actively tracked individual user adoption and activity levels and committed to a monthly schedule in which we conducted follow-ups with high performers to learn about their best practices, and with low performers to find out what was preventing them from using the programme and to provide them with personalised support.

Adoption in the U.S. grew faster than expected, as we communicated initial success stories that inspired other salespeople to join. Activity levels continue to range between adequate and robust, with the primary drivers of robust activity being use of the more automated Hearsay Social publication functions (one click, several posts), and ease of use via mobile devices, which has enabled participants to sustain activity levels even when they spend most of their working day outside of a formal office setting.

At the time of writing, individual sales use of social media for business is still too new to draw hard conclusions. We do, however, have qualitative evidence proving that the addition of LinkedIn to the sales-force arsenal has created sales opportunities that would not have existed if LinkedIn had not been in place to broker the connection.

We have also witnessed numerous instances of social engagement setting the stage for a potentially more productive sales conversation follow-up.

VP Client Insights, Marco Bailetti notes, *"Early correlation analysis suggests there's a relationship between social activity and positive sales outcomes. We're thinking about approaches to better attribute value to digital engagement across multiple channels, including social media, as it relates to sales outcomes. It's still preliminary, but we've already seen that social is creating or capturing opportunities that could otherwise have been left on the table, enabling us to deliver a better customer experience."*

Some of Franklin Templeton's corporate-level social media activities are now almost five years old (Dr. Mark Mobius's blog and @MarkMobius Twitter), so a more concrete structure of quantifiable metrics, benchmarks and targets is in place there. In essence, it breaks down into 4 components:

1. AWARENESS	Measured in community size, views and impressions. You have to reach a certain tipping point in community size and traffic in order to achieve the other goals, but awareness figures do not indicate dynamic interaction with content, which is why this is considered a base metric.
2. ENGAGEMENT	Measured in audience retention, likes and replies. This is where you see trackable indications that a user has actively interacted with content, indicating that the content is topical and interesting.
3. ADVOCACY	Measured in shares and re-tweets, advocacy indicates the user liked the content enough to put his or her stamp of approval on it, sharing it with the members of his or her own social community. This has the effect of increasing the reach of the shared content by extending it to people who are not members of the firm's communities. Studies have shown that content your connections promote is content you are more likely to consume, so the likelihood of shared content being read by these recipients is higher than if they had encountered it by accident or through advertising.
4. ACTION	Measured in CTR (Click Through Rate), which can also mean downloads. Often this also translates into increased awareness, such as when a financial adviser downloads a pdf of a brochure to share it with his clients.

As an example, if the business goal is to support a campaign message, then the awareness metric would indicate success or lack thereof by demonstrating how many additional incremental pairs of eyes saw campaign content as a result of the social activity. The engagement metric is an indicator of whether that campaign message is resonating, providing either confirmation that the message is on-target or needs to be re-worked. Incidents of advocacy and action help boost other metrics and suggest resonance with the audience.

On rare occasions there are social interactions which are clearly linked to a specific sales outcome, but it is far more common for social activity to be but one of many touch points contributing to an ultimate sale. However, certain social behaviours or behaviour patterns may provide a basis on which to predict likely readiness for a sales conversation. And knowing that even a single digital touch point can vastly increase the likelihood of a previously un-touched client doing business, the potential for digital publication to create sales opportunities is seemingly limitless.

Looking ahead, Franklin Templeton has no plans to slow the pace of social media expansion. As the firm kicks off its fiscal year, the focus is largely on the overlap between social media and sales, looking more specifically at ways to connect with and serve more clients in the social space, leveraging digital communications as a means to extend the reach of each individual salesperson, and, by extension, the reach of the brand and its messages.

To the **point**:

- It's clear there's a global appetite for investing insights within the social media space. Legal and compliance issues are complicated, but they're also solvable. There are risks; we believe the potential rewards outweigh them
- A mix of individual level and corporate level social media activity will likely yield a more comprehensive mix of results with real business impact
- Written policies and procedures supported by technology are the administrative backbone of an effective social media program
- A global program should be able to take advantage of central resources and learning, but each market will require local accommodations
- Success is measured first in adoption, then in the awareness, engagement, action and advocacy metrics that indicate progress towards pre-determined business goals

New tax regulations for investment funds

Austria, France, Germany, Ireland, Luxembourg, Netherlands, United Kingdom, Switzerland

2013 was dominated by the changes triggered by the Alternative Investment Fund Managers Directive (AIFMD). Hence, this article mainly focuses on the amendments to regulations and the fiscal consequences of AIFMD for the taxation of investment funds. Other amendments to the existing taxation rules for investment funds encompass regulations aimed at fine-tuning the tax assessment provisions, as well as correcting clerical errors in previous tax legislation.

Austria

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In the course of the implementation of the AIFM Directive (2011/61/EU) into national law, two major changes with regard to the taxation of mutual funds have been incorporated into the Austrian Mutual Fund Act. Moreover, additional changes for mutual funds will enter into force for funds´ business years starting in 2013, which were previously implemented into the Austrian Mutual Fund Act, as part of the last tax reform in Austria.

Changes following implementation of the AIFM Directive

- **Definition adopted for foreign mutual funds**
  Foreign mutual funds that are set up as UCITS (Undertaking for Collective Investment in Transferable Securities) or AIFs (Alternative Investment Funds) qualify as foreign mutual funds from a tax viewpoint, irrespective of the fund's legal set-up and risk diversified portfolio. It has yet to be decided whether the term 'AIF' will relate to the regulatory definition, but if it does, it is unclear how this can be proved in practice, as only alternative investment fund managers obtain a licence or a registration from the regulatory authorities, but not the respective AIF.

  Foreign vehicles that are not set up as UCITS or AIF can qualify as foreign mutual funds if the assets are invested in accordance with the principles of risk diversification, and if the following criteria are met:

  - The vehicle is not subject to a comparable corporate tax (the corporate tax rate is currently 25%) in the jurisdiction where it is set up
  - The profit of the vehicle is subject to a corporate tax rate that is 10 percentage points lower than the Austrian corporate tax rate (currently 25%), or
  - The vehicle is tax exempt in the jurisdiction where it is set up

  Tax transparent vehicles that are not taxed directly in the jurisdiction where they are set up do not have to go through the above-mentioned criteria test; they are treated as transparent mutual funds in Austria in the case of a risk diversified portfolio.

  The above-mentioned definition is applicable for funds´ business years starting on or after 21 July 2013.

- **75% reduction in loss carry forwards**
  It will only be possible to offset 25% of loss carry forwards that could not be set off against taxable gains in funds´ business years starting in 2012. This will result in a cut off of loss carry forwards of 75%. This new tax rule will only apply to Austrian private investors; institutional investors will retain a 100% set-off of loss carry forwards. The following amounts of taxable gains can be used to set off losses for Austrian private investors:
  - Funds´ business years starting in 2012—40% of realised net gains from equities and equity-linked derivatives
  - Funds´ business years starting in 2013—50% of all realised net gains
  - Funds´ business years starting in 2014 and beyond—60% of all realised net gains

  The amount of the 25% loss carry forward for private investors will have to be reported by the Austrian tax representative of the foreign mutual fund with separate codes to the Austrian Kontrollbank.

  The above described principles only apply to realised gains that are part of Deemed Distribution Income (DDI). In the case of distributions relating to business year 2013, the entire amount of distributed gains will be taxable.

Changes for funds´ business year 2013 already implemented

- **Equalisation on dividends and gains**
  Equalisation amounts on dividends and realised gains and losses (see above) will be taxable, and will be part of the DDI starting with business year 2013. In previous business years, only equalisation amounts on net interest income have been part of the DDI.

- **Amended taxation of distributions**
  Distributions relating to business year 2013 and beyond are deemed to have been made out of the following components in the following order, without exception:
  1. Current income (interest, dividends deducted from expenses)
  2. Income carry forwards (tax-free if already taxed as DDIin the past)
  3. Realised gains (including tax-free gains as mentioned under the section above, i.e. distributed gains will always be treated as taxable distribution)
  4. Gains carry forwards
  5. Substance (tax neutral)

  Tax-free parts of distributions will reduce the acquisition cost of shares in the fund (if acquired by an Austrian private investor after 31 December 2010) in order to avoid a double non-taxation in the event of redemption, i.e. the tax-free distributions will qualify as a taxable capital gain in the event of redemption.

The system of taxation of mutual funds in Austria has not changed significantly, there are some amendments entering into force for business year 2013 or business years starting on or after 21 July 2013

France

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New tax measures are currently being discussed by the French Parliament for the vote of the 2014 budget. The final vote will take place shortly, but these rules could still be subject to modification

General measures

Increase in the exceptional Corporate Income Tax (CIT) surcharge

Companies with annual revenue exceeding €250 million are currently subject to an ex-ceptional CIT surcharge at a rate of 5% until 30 December 2015.

The current 5% rate of this surcharge is set to increase to 10.7%. This would lead to an effective CIT rate of 38% (instead of 36.1% currently).

Exceptional tax on high salaries paid by companies

A 50% tax will be levied on the portion of remuneration paid to employees exceeding €1 million per year per individual. This annual tax is to be paid by companies and will apply to remuneration paid or attributed in 2013 and 2014, with a cap set at 5% of annual revenue.

It is worth noting that the definition of 'remuneration' falling within the scope of the new tax is quite broad and includes benefits in kind, bonuses and stock options or free shares.

Specific measures relating to the asset management industry

New tax regime of capital gains on shares applicable to individual investors tax resident in France

The asset management industry could be directly impacted by the new tax regime of capital gains on shares. The general objective is to apply income tax rules and rates to capital gains.

This new regime clarifies the tax rebates regime, which depends on the holding period.This favorable regime applies to the transfer of shared equity rights and to the distribution of assets by capital risk funds (Fonds Communs de Placement à Risques or FCPR) and the distribution of capital gains by French or foreign collective investment schemes.

** Taj is a member of the Deloitte Touche Tohmatsu Limited*

Holding period and tax rebates

Holding period	Rebate
Less than 2 years	0%
2 to 8 years	50%
Over 8 years	65%

However, in some circumstances, it might prove difficult to meet the conditions needed to benefit from this exemption. For example, capital gains deriving from the sale or repurchase of shares/units in collective investment schemes (UCITS type) only benefit from the exemption regime if an investment ratio is met (i.e. 75% of the investment must be in shares). This investment ratio should be met before the end of the second fiscal year following the creation of the fund. For funds created before 1 January 2014, this investment ratio has to be met before the end of the first fiscal year that ends after 1 January 2014.

Unfortunately, the favourable tax regime applicable to the re-investment of the proceeds of share disposals where shares have been held for more than eight years is to be removed. From January 2014, capital gains will no longer benefit from this incentive.

Other proposals, such as the introduction of a special 30% withholding tax on the distributions of capital gains for non-residents were rejected.

The extension of the scope of the French FTT has also been rejected so that it would not get in the way of the already difficult discussions on the European FTT.

Summary of the items that can give rise to a tax rebate

	Rebate/discount regime	Comments
Shares	Yes	No specific conditions
Equity rights or instruments	Yes	No specific conditions
Distribution of assets by a capital risk fund	Yes	No specific conditions
Disposal of fund units Distributions of capital gains by a fund	Yes	Funds have to respect an investment ratio of at least 75% in qualifying shares
Disposal of shares/units in a capital risk fund (FCPR) Distribution of capital gains by a capital risk fund	Yes	Funds have to respect an investment ratio of at least 75% in qualifying shares, except for certain capital risk funds

Germany

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A draft law was passed in respect of changes to the German Investment Tax Act (GITA), dated 24 October 2013. These changes, adjusting tax regulations in order to match with the new provisions, were anticipated by the Financial Investment Code (Kapitalanlagegesetzbuch) replacing the German Investment Act (GIA). The new investment tax law is coextensive with the former draft AIFM Tax Amendment Act, which became invalid at the end of the previous legislative period on 22 September 2013. After the re-election of the conservative Christian Democrats of Chancellor Angela Merkel, at the time of writing (December 2013), they will more than likely form a grand coalition with the Social Democrats.

Following the re-election of Chancellor Angela Merkel's Christian Democrats, the proposed amendments are due to come into force during the 2014 tax assessment period

As the old Investment Tax Act refers to the outdated GIA to some extent, for the time being there was a lack of certainty for some investment vehicles in determining and publishing the respective bases of taxation.
The German Ministry of Finance (BMF) therefore issued a circular letter on 18 July 2013 dealing with transitional rules, stating that the tax authorities will not make any challenges if regulations contained in the outdated Investment Tax Act were used for the taxation of investors in the respective vehicles that comply with the old GIA. This shall be valid until the aforementioned replacement tax law has passed the legislation and comes into force (before 31 December 2013).

Changes to investment tax law during 2013

- **Tax exemption of dividends and capital gains**
  The legislation passed a change in law as an adaption within the Corporate Tax Act regarding the tax exemption of dividends and capital gains for corporations. After 1 March 2013, the 95% tax exemption for dividends is only applicable to shareholdings greater than 10%. In general, this also applies to mutual funds. Under the new law, the fund administrator has to calculate and disclose the old AKG1 for individual business investors and partnerships as well as a new AKG2 for corporations.

- **Cost allocation of performance fees**
  In its circular dated 3 April 2013, the BMF clarified the existing law concerning the allocation of performance fees relating to fund investments. Accordingly, the performance fee has to be allocated in accordance with the contractual arrangement within the fund documents (prospectus, supplements, etc.), i.e. it has to be allocated to realised gains to the full extent, if the calculation of the fee is only based on realised gains. Alternatively, the performance fee has to be allocated partly to realised gains and partly to ordinary income, or to the full extent to ordinary income, if the calculation is based on those components.

Changes to investment tax law until 31 December 2013

- **General cost allocation**
  Under current rules, it is possible to allocate general costs primarily to ordinary taxable income (e.g. dividends, interests), and thus reduce the investor's taxable deemed distributed income derived from fund investment.

  According to the new rules, general costs would be allocated to taxable ordinary income as well as to capital gains. If the ordinary income and the sum of capital gains and losses are negative, there is a fixed ratio of 50% for the allocation between ordinary income and capital gains. This means that the option to categorise 10% of indirect costs as non-deductible expenses would be abolished. However, there will be no changes to the allocation of direct costs.

- **Mandatory source order for distributions**
  The new investment tax law contains the following ruling: for tax purposes, a distribution is deemed to stem from all income of the current and previous years, until substance, within the meaning of the share-class capital, is affected.

- **Anti-abuse rules applicable to bond-stripping structures**
  A further paragraph of the new law aims at preventing certain structures involving the change in ownership rules of bond coupons, known as 'bond-stripping structures'. Until now, these structures have been used to generate taxable income from the disposal of stripped interest coupons at the fund level, which can be used as deemed distributed income to be offset against other losses, thereby avoiding forfeiture of the investor's tax losses under special regulations of the Corporate Income Tax Act. Future losses from the disposal of fund units could be set off against other taxable income.

- **Conservation of the status quo**
  There are reliefs, which are beneficial for the fund industry, regarding the proposed grandfathering rules. There is a right of continuance if partnership units were in the fund portfolio before the parliamentary decision regarding the draft law. Even more important is a minimum grandfathering rule for three years, for (sub-)funds in issue before 22 July 2013 (coming into effect of the Financial Investment Code).

Ireland

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REITS

Finance (No. 1) Act 2013, introduced Real Estate Investment Trusts (REITs) into Ireland. This is a good news story for the Irish fund and property sectors that also provides a platform on which a world class REIT environment can be built and refined.

The REIT regime provides tax exemption in respect of the income and chargeable gains of a property rental business held within a company that satisfies a number of conditions. Dividends paid by a REIT out of its rental income will be subject to a 20% dividend with holding tax, for which recipients will be liable. However, in many cases it is possible to reduce the rate of withholding tax under the terms of a relevant treaty between Ireland and the investor jurisdiction (see paragraph on treaties below). Capital gains made by non-Irish resident investors on their disposal of shares in the REIT are not taxable in Ireland. Transfer tax of 1% applies to any issuance or transfers of shares in the REIT.

The REIT brand is well recognised globally, and the Irish regime has been introduced with a view to attracting international investors to the Irish property market, as well as the international property market. Through the REIT structure, Irish financial institutions should have a growing number of opportunities to find buyers for distressed property assets, freeing up much needed capital for investment in other projects. The first Irish REIT was successfully launched on 18 July 2013, and a number of others are in the process of being established. We expect REIT activity to ramp up significantly in 2014, following the success of the first entrants.

Investment Limited Partnerships

In response to calls by the Irish international fund industry, the Finance (No. 1) Act 2013 included measures to treat Irish funds established as Investment Limited Partnerships (ILPs) in accordance with the Investment Limited Partnerships Act 1994 as transparent for Irish tax purposes. The tax treatment of ILPs after this date will be very similar to the treatment of Common Contractual Funds (CCFs).

From an Irish tax perspective, ILPs are not chargeable to tax in respect of income and gains (i.e. profits) on underlying investments, but those profits are treated as accruing to the unitholders of the ILP in proportion to their relative investment in the ILP, as if the unitholders held a corresponding share in the underlying investments directly.

This new tax treatment applies to ILPs authorised by the Central Bank of Ireland on or after 13 February 2013. This important change to the ILP framework will result in a tax transparent fund structure suitable for private equity and real estate investments, and sends a clear and positive message that Ireland is AIFMD ready and open for business.

Common Contractual Fund (CCF)

The Common Contractual fund (CCF) is an Irish regulated asset pooling fund structure. Asset pooling enables institutional investors to pool assets into a single vehicle fund with the aim of achieving cost savings, enhanced returns and operational efficiency through economies of scale. Experience of existing CCFs shows a saving of 10-20 basis points.

The first Irish REIT was successfully launched on 18 July 2013, and a number of others are in the process of being established

A CCF is an unincorporated body established under a deed whereby investors are 'co-owners' of underlying assets that are held pro-rata to their investment. A CCF is usually established by a management company and investors must not be individuals, i.e. only institutional investors are permitted. CCFs are authorised and regulated by the Central Bank of Ireland and can be structured as a UCITS or a non-UCITS fund. A CCF is not a separate legal entity and is transparent for Irish legal and tax purposes.

As the CCF is fiscally transparent, it is therefore exempt from Irish tax on its income and gains. Investors in a CCF are treated as if they directly own a proportionate share of the underlying investments of the CCF. Under Irish tax law, the profits that pertain to the CCF are therefore treated as arising or accruing to the investors in the CCF as if they had never passed through the CCF. As the CCF is tax transparent, it is the double tax treaty between the investor jurisdiction and investment jurisdiction that is relevant for treaty relief.

Many new Irish double tax treaties confirm the transparency of the CCF in treaty partner locations. To date, at least 19 jurisdictions, including the United States, recognise the Irish CCF as fiscally transparent.

Rates of investment undertaking tax

Finance (No. 2) Bill 2013 introduced an increase in the rate of tax withheld on payments from Irish resident funds to Irish resident investors in respect of distributions, redemptions, transfers and deemed disposals. For Irish funds, which previously withheld tax at 33% or 36%, depending on the frequency of the payments in question, a new rate of 41% will now apply to all payments to investors, regardless of the frequency of those payments. The rate applicable to 'personal portfolio investment undertakings' increases from 56% to 60%, but increases to 80% where the payment has not been correctly included in the income tax return.

The increased rates will apply to payments/deemed payments made on or after 1 January 2014.

Mandatory reporting for Irish funds

The Irish tax authorities issued a new reporting obligation for Irish funds. This is being commonly referred to as Section 891C Reporting. Irish domiciled funds are now required to report details of any Irish resident investors to the Irish Revenue Commissioners on an annual basis. Details are required to be submitted by 31 March each year in relation to the fund itself, the Irish resident investors and the investment held by each Irish investor.

New tax treaties

Ireland continues to expand its network of double taxation treaties, 70 of which have now been signed. The legal procedures to bring our most recent treaties into force—treaties with Egypt, Ukraine and Thailand—are now being followed. In addition, negotiations for new agreements with Azerbaijan, Jordan and Tunisia are ongoing.

The ever-increasing number of Irish treaties serves to improve returns for investors in Irish funds, with Irish funds recognising the benefit of reduced rates of foreign tax in treaty countries in many cases.

Luxembourg

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In Luxembourg the AIFMD was transposed through the law dated 12 July 2013. The new law includes various tax and legal aspects not directly required by the directive, but which are aimed at strengthening Luxembourg's position as a fund centre for UCITS, as well as for alternative fund managers. The law includes the following measures:

Creation of the 'special limited partnership' (SCSp)

The draft law modifies the Law of 10 August 1915 on commercial companies, including:

1. A modernisation of the legal regime applicable to common limited partnerships or SCS *(Sociétés en Commandite Simple)*
2. A new vehicle, the special limited partnership or SCSp *(Société en Commandite Spéciale)*

While most of the provisions applicable to these entities are similar, the main difference between the SCS and the SCSp is that the SCSp does not have a legal personality. The SCSp has been more particularly envisaged for unregulated funds, specialised investment funds (SIFs) and investment companies in risk capital (SICARs). The main advantage of the SCSp is that it is comparable to the Anglo-Saxon partnership model widely used for fund structuring, especially in the private equity and real estate investment sectors.

From a tax standpoint, the primary measure of Luxembourg's AIFM law is the full tax transparency of the SCS/SCSp for Corporate Income Tax (CIT), Municipal Business Tax (MBT) and Net Wealth Tax (NWT) purposes. In addition, the distribution of dividends by a SCS/SCSp is not subject to withholding tax. Full tax transparency applies when the corporate GP of the SCS/SCSp owns less than 5% of the partnership interests, and when the SCS/SCSp does not carry out a commercial activity.

Introduction of a new tax regime for carried interest

Aside from clarifying the Luxembourg tax regime applicable to carried interest paid to employees of AIF managers and to management companies of an AIF, the AIFM law introduces a beneficial temporary regime.

Beneficial temporary regime

Beneficiaries	Employees of AIF managers and management companies of an AIF
Tax rate applicable to carried interest	Progressive rate up to 10.335% (extraordinary in-come regime)
Conditions	Beneficiaries are those who: • transfer their tax residence to Luxembourg between 1.1.2013 and 31.12.2018 • have neither been a Luxembourg tax resident nor subject to taxation on their professional income in Luxembourg during the 5-year period preceding 2013 • did not receive any advance tax payment relating to their carried interest • can demonstrate that prior to the payment of their carried interest, committed capital has been fully repaid to investors
Length of the regime	11 years from the year the beneficiaries take on the position in Luxembourg that entitles them to the carried interest

- **Capital gains**
  Capital gains that the beneficiaries of carried interest (whether or not they benefit from the favourable regime) may derive from the sale or redemption of their shares/units if the AIF are taxable according to the usual tax regime applicable to capital gains, i.e.:
  1. exemption if the shareholding did not exceed 10% at any point in time during the five-year period prior to the sale or redemption, and
  2. the holding period exceeds six months

- **Combination with the 'highly skilled worker' regime**
  Combined with the advantages granted by the revised tax regime for highly skilled workers, Luxembourg—which is a long-standing location for investment funds—becomes a location of choice for fund managers as well. Whereas the tax regime for highly skilled workers may already lead to substantial yearly savings of personal income tax for an executive whose compensation package is properly structured, this executive would also save 75% tax on carried interest through the beneficial temporary regime

Broadening the VAT exemption scope for management services rendered to funds

From a VAT perspective, the objective of the AIFM law is to extend the VAT exemption scope of the previous eligible vehicles to the assimilated investment vehicles located in another EU member state, as well as to any AIF, as defined in the law. The anticipated goal of that measure is to avoid any VAT distortion of competition between the management of investment vehicles registered either in Luxembourg or another EU member state. A Luxembourg-based management company delegating part of its management tasks (still viewed as a 'whole') to a third-party provider (established in Luxembourg or abroad) continues to benefit from the VAT exemption on management services if all the VAT conditions are met, irrespective of whether the relevant investment vehicle is registered in Luxembourg or in another EU member state.

There is no doubt that the granting of a VAT exemption to the management of AIFs, together with the increase of the cross-border management to (eligible) EU investment vehicles, could impact the corresponding input VAT deduction right of the managers. In this respect, the Luxembourg VAT authorities issued Circular 765 dated 15 May 2013 and consider that the use of the general prorata method (yearly ratio of the taxable transactions, in respect of which VAT is deductible over the total turnover within the scope of VAT) remains applicable only in relation to overhead expenses that cannot, by nature, be allocated to any activity in particular. As from 2013, taxpayers must switch to an alternative methodology based on appropriate and objective allocation keys. Luxembourg-based management companies with both taxable and exempt activities should closely monitor this.

On 7 November 2013, the Luxembourg VAT Authorities issued Circular 723 ter regarding the application of the VAT exemption (Article 44§1 d) of the Luxembourg VAT Law (LTVA) in respect of risk management services for investment funds. Risk management services rendered to investment funds benefit from a VAT exemption under Article 44§1 d) LTVA.

Such services should include the monitoring and measuring of risk of positions and of their contributions to the overall risk profile of the portfolio (as defined in Article 51 of the Directive 2009/65/EC). The fund management VAT exemption should similarly apply to risk management services rendered to alternative investment funds (Article 15 of the Directive 2011/61/EU).
The Luxembourg VAT authorities confirmed that risk management services are to be seen, for VAT purposes, as being part of fund management. Risk management services outsourced by the management company must be specific and essential to the management of (alternative) investment funds (as further defined in Circular 723 bis 30 April 2010) in order to benefit from the fund management VAT exemption.

In any case, the application of this exemption for outsourced services should be analysed on a case-by-case basis, by considering Circulars 723, 723 bis and 723 ter.

Cross-border management of AIFs

- In a similar way to the UCITS regulations, under the AIFM law, an authorised AIFM established in Luxembourg is allowed to manage AIFs established in other EU member states. From a tax point of view, these cross-border management services should not create any management or control issues. The AIFM law specifically states the principle of non-tax liability for those AIFs established outside Luxembourg that have their effective centre of management or central administration in Luxembourg
- The AIFM law also sets out minimum substance requirements to be met at the level of the AIFM that illustrate the convergence between the substance required from a regulatory perspective and the substance required from a tax viewpoint

Netherlands

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This year there have been a few positive changes regarding the Dutch FBI (fiscal investment institutions or fiscale beleggingsinstelling). FBIs are subject to a 0% corporate income tax rate in the Netherlands, and they have access to the Dutch tax treaty network. This has made it a very tax-efficient fund vehicle for (high) dividend as well as real estate investments. Of course certain requirements must be met, but some of these have or will become easier to fulfill.

Performing ancillary activities for RE-FBIs

FBIs were only supposed to perform passive investment activities such as real estate leasing. They were previously not allowed to perform ancillary activities related to real estate or to hold 100% of the shares in a subsidiary that is engaged in business activities, because these did not qualify as 'passive investment activities'.

In the 2014 tax plan, changes are proposed that will enable FBIs to offer additional services relating to the development and management of their investment property. FBIs will be allowed to do this using a 100% (regular taxed) subsidiary whose purpose and actual activities consist of performing ancillary activities directly related to the real estate investments made by the FBI. For example, such activities could be cleaning, catering and reception services. It will therefore be easier for FBIs to act as the parent company of a (cross-border) real estate fund structure.

Less stringent shareholder requirements following the implementation of the AIFMD

The Netherlands implemented the AIFMD earlier this year. This could prove to be an interesting development for the use of FBIs.

There have always been different (less stringent) shareholder requirements for FBIs that were listed or that were supervised by the Netherlands Authority for the Financial Markets *(AFM or Autoriteit Financiële Markten)*. In the past, only a relatively small number of FBIs fulfilled the criteria to use the less stringent shareholder requirements. The implementation of the AIFMD has placed a lot of FBIs under the supervision of the AFM. So most FBIs (being a UCITS or an AIF) will now qualify for these more favourable shareholder requirements. This means that an individual shareholder can hold up to 25% of the shares of a FBI. Legal entities are allowed to own up to 45% of the shares if the shareholder is taxed for CIT-purposes, or up to 100% in the case of a tax-exempt shareholder.

Real estate investment funds: no transfer tax

If shares in a real estate investment fund are sold, a Real Estate (RE) transfer tax might be levied. There was already an exemption to this rule for the transfer of shares in a RE corporation (funds with legal personality), as long as less than a third of the shares were bought. For RE funds without legal personality, the exemption rules were more complex and could not always be easily fulfilled. In the 2014 tax plan, it has now been proposed that the 'up to 1/3-exemption' will apply as long as the real estate fund is a collective investment fund regulated by the Dutch Financial Supervision Act *(Wet financieel toezicht or Wft)*.

Withholding tax reclaim opportunities

Last year, the Finnish investment fund case required special attention. According to the Court of Appeal in Den Bosch, a Finnish investment fund was entitled to a full refund of Dutch withholding tax on dividends, because it was comparable to the domestic situation of exempt corporations which are entitled to such a refund. Recently, the Dutch Supreme Court rejected the Finnish investment fund's reclaim. Contrary to the Court of Appeal, the Dutch Supreme Court decided—without putting any preliminary questions to the European Court of Justice—that the mere fact that the fund was exempt from tax in Finland did not impose an obligation on the Netherlands to refund the Dutch withholding tax on dividends. Moreover, it ruled that the Netherlands could apply a test to see whether the fund would be exempt from tax—and thus entitled to a refund—if it were located in the Netherlands. The outcome of that test was negative. The Finnish investment fund would be fully subject to tax. Finally, the Dutch Supreme Court also considered whether the Finnish investment fund was comparable to a Dutch FBI, which is—under certain conditions—entitled to an 'indirect refund' of Dutch withholding tax. The Dutch Supreme Court decided that the Finnish investment fund was not comparable, because—unlike a FBI—it had not distributed its annual income to its shareholders.

In another case of the Court of Appeal in Den Bosch, it was decided that a Belgian private person was entitled to a partial refund of the Dutch withholding tax deducted on portfolio dividends. The Court of Appeal considered that because a Dutch resident could have credited the Dutch withholding tax, the Belgian should not be in a worse position. This case is currently pending before the Hoge Raad as well.

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In its 2013 budget, the UK government announced an investment management strategy, covering marketing, regulation and taxation, with the intention of improving the attractiveness of the United Kingdom as a fund domicile.

This included an undertaking to make the UK tax system for investment management fairer, simpler and more streamlined, and therefore a number of proposed measures were consulted on in summer 2013.

Cross-border management of alternative investment funds

In response to the introduction of the 'management company passport' under UCITS IV, which enables a UCITS fund to be managed cross-border, the United Kingdom introduced legislation (s363A TIOPA 2010) in July 2011 to enable an offshore UCITS fund to be managed from the United Kingdom without there being a risk that it would cause the fund to be UK tax resident. This has been well received by the industry and we have seen a number of investment managers capitalise on the legislation.

HM Revenue & Customs (HMRC) consulted this summer on the government's proposals to extend these rules to offshore non-UCITS funds that have a UK Alternative Investment Fund Manager (AIFM) or a UK branch of a non-UK AIFM, i.e. it will be possible for an offshore non-UCITS fund to be managed by a UK AIFM without there being a risk that this could cause the fund to be UK tax resident. This will enable the United Kingdom to take advantage of the opportunities provided by the Alternative Investment Fund Managers Directive (AIFMD). We are expecting draft legislation to be included in the Finance Bill 2014.

Gross interest distributions from UK funds

UK open-ended investment companies (OEICs) and authorised unit trusts (AUTs) are permitted to make interest distributions (rather than dividend distributions) in certain circumstances. The fund is generally required to withhold basic rate income tax at 20% on interest distributions. However, where certain conditions are met, which are designed to ensure that the investor is non-UK resident, the interest distributions can be made gross. This can create a disincentive for non-UK distributors to market UK bond funds, because the distributor would need to determine whether any of the investors are UK residents.

HMRC consulted proposals to enable gross interest distributions to be paid by UK funds marketed exclusively outside the United Kingdom. There would be no requirement for the distributor to establish the tax residence of investors who have non-UK addresses. HMRC believes that this proposal should help interest-paying UK funds attract more non-resident investors. Regulations were laid in December 2013 and draft HMRC guidance is expected to be published in due course.

Abolition of schedule 19 Stamp Duty Reserve Tax

In its 2013 budget, the UK government announced the abolition of schedule 19 Stamp Duty Reserve Tax (SDRT)—the UK fund specific stamp duty that arises on redemption of shares/units in OEICs and AUTs starting April 2014. This is very positive news for the attractiveness of UK authorised funds, and something that the industry had been requesting for many years. The tax has a headline rate of 0.5%, but owing to various reduction fractions, the actual rate is often much lower. We are expecting the draft legislation to be included in the Finance Bill 2014.

Previously, UK investors relied on the 'roll-over relief' rules that applied to reorganisations of normal corporates

Tax transparent funds

The UK update on the taxation of investment funds in issue 10 of Performance focused solely on a new UK tax transparent fund vehicle, formally known as Authorised Contractual Schemes (ACS). The legislation to introduce the ACS came into force in June 2013, and the UK financial regulator has been able to accept applications for authorisation from July. We have seen a great deal of interest from life insurance companies considering whether the ACS would present a suitable alternative offering, from pension schemes looking for a tax-efficient way to pool their investments and from investment managers seeking to rationalise their fund ranges while offering a tax-efficient solution to investors. At the time of writing, we eagerly await the launch of such a fund vehicle.

Exchanges, mergers and reconstructions

New legislation, effective from 8 June 2013, has been introduced to provide 'roll-over relief' on chargeable gains/losses arising on exchanges, mergers and schemes of reconstruction of collective investment schemes (which include both UK and offshore funds) for UK investors. Previously, UK investors relied on the 'roll-over relief' rules that applied to reorganisations of normal corporates. This generally worked, but there were areas of uncertainty in certain specific circumstances. This new legislation provides greater certainty and also legislates for the chargeable gains treatment of exchanges between share classes of the same sub-fund (previously reliance was generally placed on HMRC guidance for share class switches). With the exception of moving from hedged to unhedged and vice versa, UK investors can generally switch between share classes of the same sub-fund without crystallising a chargeable gains event.

Unauthorised unit trusts

Following consultations in 2011 and 2012, draft regulations amending the taxation of Unauthorised Unit Trusts (UUTs) and their unitholders were published in September 2013. UUTs can be either exempt or non-exempt, depending on the tax status of the unitholders. The changes are generally intended to prevent the use of non-exempt UUTs for tax avoidance by bringing them within the scope of corporation tax, and to simplify the rules as well as reduce existing administrative burdens for exempt UUTs and the investors. The changes will also require exempt UUTs to be approved by HMRC.

UK corporates investing in UK and offshore funds

As part of a wider consultation on the modernisation of the taxation of corporate debt and loan relationships, the UK government has proposed the abolition of two fund- specific rules: (i) the 'bond fund' rules—the rules that require a UK corporate to treat an investment in a UK or offshore fund as a loan relationship, where the fund holds more than 60% in interest-bearing assets at any time during the corporate investor's accounting period; and (ii) the 'corporate streaming' rules, which require a UK corporate investor receiving dividend distributions from a UK OEIC or AUT to treat the relevant percentage of the distribution as taxable, unfranked investment income and balance as non-taxable franked investment income.

An HMRC working group, on which Deloitte is represented, has been established to discuss the proposals and, at the time of writing the article, the discussions have focused on the proposals to abolish the 'bond fund' rules. These rules were originally introduced as a piece of anti-avoidance legislation, but it was understood that they had been subject to abuse, hence the proposals for their abolition. However, it has been acknowledged that this would create a mismatch for UK corporates between investing in interest-bearing assets directly and via a collective investment scheme. This is of particular concern to UK life insurance companies.

It was announced in the Autumn Statement that the government will introduce legislation to enhance, clarify, rationalise and prevent abuse of the 'bond fund' rules, and to permit corporate investors to make a claim in certain circumstances to disapply the rules. We are expecting the proposed changed to the legislation to be included in Finance Bill 2014.

The proposed abolition of the corporate streaming rules is due to be discussed by the working group in the new year. Concerns have been raised by the life insurance industry in particular, as the corporate streaming rules effectively enable them to reclaim the tax imposed on 'balanced funds'. The corporate streaming rules are also fundamental from a tax efficiency perspective for life companies investing in property alternative investment funds (an elective regime for UK OEICs that invest in property).

Management fee rebates

To coincide with the Retail Distribution Review (RDR), HMRC issued a policy statement, followed by regulations, to clarify the obligation to withhold tax on rebates of management fees. Generally, there should be a requirement to withhold basic rate income tax at 20% where the rebate meets the definition of 'qualifying annual payment' and it is not an 'excepted payment' This was not the approach that had previously been adopted by the industry as a rule. However, the RDR should indicate a move to 'clean share classes' (i.e. with reduced management fees), such that the rebates of management fees that have a withholding tax obligation become less common.

> We are expecting the draft legislation to be included in the Finance Bill 2014

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Target funds—de minimis rule for tax reporting

In August 2013, the Swiss Federal Tax Administration (SFTA) introduced new de minimis rules for tax reporting. Generally, the Swiss tax system knows two categories of invest-ment funds: transparent collective investment funds and non-transparent ones. The first category includes contractual funds (FCPs), SICAVs and Limited Partnerships for Collective Capital Investments (LPCCIs). Such funds are considered tax transparent as long as they do not have direct holdings in real estate, since the profit arising from real estate (including rental income as well as capital gains from the disposal of real estate) located in Switzerland is taxed separately from any other income. The second category includes SICAFs, which are treated differently, namely as common limited companies.

Where collective investment funds invest in other collective investment schemes, different levels of income may result either from tax transparent collective investment schemes with distribution or with reinvestment. From the tax perspective, transparency must be ensured at all levels. All income generated by target funds and calculated or reported for Swiss or foreign collective investment schemes must be fully booked at the level of the fund-of-fund. Therefore, the fund-of-fund is obliged to provide an aggregated account each year, reflecting the proportionate investments in target funds.

Since some funds invest only occasionally and to a very limited extent in target funds, the new de-minimis rules have been introduced limiting the administrative burden for such investments. If overall, a collective investment scheme invests less than 10% of its total assets in target funds, then in the case of an investment of less than 3% of the total fund assets in a respective target fund, the following may be aggregated as taxable income in the fund-of-funds instead of the traditional reporting:

- Distribution target funds—all accrued distributions during the past financial year of the fund-of-funds
- Accumulation target funds—the positive difference in the net asset value in the past financial year; negative differences will not be taken into account

If such target funds have taxable values stated in the official list of securities (Kursliste) of the SFTA, these are to be aggregated.

The decision to apply the newly introduced deminimis rule per target fund must be adhered to for five years. Once this period expires, it will be automatically extended for another five years, provided the fund management company does not inform the SFTA about a change in the decision. The new deminimis rule for calculating taxable income may be used for the first time for financial years ending on 30 September 2013 or later.

Swiss accumulation funds—due date for withholding tax

Generally, dividends derived from units in a collective investment scheme are subject to Swiss withholding tax at 35% if the issuer of these units is a collective investment scheme with a registered office or principal management in Switzerland, or if the issuer is a foreign collective investment scheme and the collective investment units are issued together with a Swiss resident, e.g. a Swiss depositary bank. The annual due date for withholding tax is defined in the Swiss Withholding Tax Act; accordingly, the Swiss withholding tax liability arises at the time the taxable income is credited. According to SFTA circular letter no. 24, dated and in force since 1 January 2009 for withholding tax and stamp duty, and circular letter no. 25, dated and in force since 5 March 2009, for direct taxes, the time the taxable income is credited is defined as the end of the financial year.

For administrative and liability reasons, in the Swiss accumulation fund industry, the deadlines are now to be brought in line with distribution funds, i.e. the withholding taxes are:

- owed for the past financial year
- due within four months of the financial year-end (period for drawing up financial statements, auditing, reporting) when income is transferred to the account for income retained for reinvestment (point of reinvestment = due date)
- payable within 30 days of the due date, at the latest, five months after the financial year-end

In the case of contractual funds, SICAVs and limited partnerships for collective capital investments that reinvest income, the tax liability arises at the moment the taxable income is credited, i.e. at the end of the financial year or, in the case of liquidation, when the remaining liquidation proceeds are distributed.

For Swiss direct income tax purposes, individual investors must pay tax on the credited investment income corresponding to their proportionate investment (exceptions apply to capital gains that are reported separately and income that has already been taxed). In the case of Swiss collective investment schemes, the income is to be allocated to the tax year in which the withholding tax was deducted. Investors generally have the right to reclaim the withholding tax deducted by the accumulation collective investment schemes based on Swiss withholding tax law or an applicable double tax treaty.

FATCA impact on Swiss fund investment industry

Switzerland has agreed with the United States on an intergovernmental agreement (IGA) that would follow the Model II approach regarding the exchange of information under the U.S. Foreign Account Tax Compliance Act. Unlike Model I, the 'Swiss' Model II does not establish the automatic exchange of information between governments, as this was not agreed by the Swiss government. Instead, the Swiss government has agreed that it will ensure that Swiss financial institutions will be able to enter into a Foreign Financial Institutions (FFI) agreement with the U.S. Treasury Department to directly report to the IRS (to become a 'participating FFI'). In other words, the underlying mechanics of Model II are the same as under FATCA itself. However, the IGA with Switzerland provides some administrative reliefs for investment funds. Annex II to the IGA between Switzerland and the USA outlines that in the case of an investment entity that is a collective investment scheme subject to the collective investment legislation of Switzerland, and if all of the interests in the collective investment vehicle are held by or through one or more financial institutions that are participating FFIs, then that collective investment vehicle will be treated as registered deemed-compliant FFI.

The qualification as registered deemed-compliant FFI requires registration with the IRS, but it is not necessary for the collective investment scheme to enter into a FFI agreement.

VAT effect in connection with the revised CISA

On 1 March 2013, the newly revised Collective Investment Scheme Act (CISA) and Article 21, Paragraph 21, Subparagraph 2, Cipher 19, Letter f of the Value Added Tax Act (VATA) came into force. The main changes concern the VAT exemption for the distribution and management services provided to collective investment schemes. The CISA no longer differentiates between public and non-public distribution, and therefore all distribution services are now exempt from VAT. In addition, based on the fact that VATA now explicitly refers to Article 3, Paragraphs 1 and 2 of CISA, management services provided to foreign funds as well as those provided to Swiss funds could be VAT exempt. According to the old practice, management services provided to foreign funds were taxable, but taxed at 0% because the services were provided abroad. Whether the SFTA will introduce a new practice for management services for foreign funds is not yet clear; an announcement is still pending. If approved, under the new practice, management services provided to foreign funds would be VAT exempt and input tax refunds would no longer be available.

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Designed and produced by MarCom at Deloitte Luxembourg