New City Initiative

The Next Five Years

Regulatory Challenges That Will Impact Asset Managers

www.newcityinitiative.org

About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of financial regulation.

Founded in 2010 by Daniel Pinto, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, an old fashioned "client-centric" approach has enabled entrepreneurial firms in the Square Mile and beyond to emerge as a growing force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

About the Author

Charles Gubert

Charles Gubert is a consultant to the NCI. He is founder of GTL Associates, a research, copy-writing and marketing consultancy to financial services institutions, and a contributing editor at Global Custodian Magazine. Prior to this, he was a research manager at Thomas Murray IDS, a consultancy and editor at COOConnect, an online title aimed at chief operating officers at alternative and long-only fund managers. He started his career as a reporter at Risk Magazine and Hedge Funds Review.

Offices

New City Initiative
3rd Floor Princes Court
7 Princes Street
London
EC2R 8AQ

Telephone: +44 (0)20 7367 5411
www.newcityinitiative.org
secretariat@newcityinitiative.org
@NCityInitiative

New City Initiative Europe
Place Edouard VII
75009 Paris
France

Telephone: +33 (1) 44 94 65 68
fr.newcityinitiative.org
gvzardo@newcityinitiative.org

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Foreword

The New City Initiative was established to both promulgate our vision for better alignment between investors and money managers – but also to give positive steer to regulators and governments as to how to achieve this. This paper outlines clearly the issues confronting our industry over the coming years and where we would either draw our members' attention to certain issues, or where we think the regulatory framework could be better structured. Wellington talked about 'The Other Side of The Hill' and I hope this document gives some clue as to what is in store for our firms in the near and medium term.

What we find, time and time again is that regulations designed to do one thing (make for a 'safer world') actually end up doing the exact opposite – normally destroying competition, making the larger firms larger and thus potentially reducing returns to investors, customer retention, and making the whole system more delicate. The powers that be have often misunderstood what 'risk' is and how it is up to a market to price it properly. Much of their efforts to somehow 'control' risk, either force it into dark corners where it cannot be easily seen or reduce liquidity in a market, where the real and ultimate risk (as seen in 2008) is a liquidity crisis. We continue to argue that better structures and culture lead to better outcomes and we remain committed to the path of less regulation and more forcing of a change in how people 'think and operate' to achieve these same goals of managing risks and being more transparent.

Our view is to promote positive change and I hope that you will find in this paper not only a new set of worries but also a set of quite simple answers to help us make for a better environment in financial services.

Dominic Johnson
Chairman, New City Initiative
CEO and Founding Partner of Somerset Capital Management LLP

10 Incoming Regulatory Initiatives

Regulation	Impact	NCI Recommendation
AIFMD marketing rules	Regulatory uncertainty around reverse solicitation and its lack of success could result in more managers utilising National Private Placement Regimes (NPPR).	The NCI advocates the extension of the pan-EU AIFMD passport to more third country managers in a timely fashion. The NCI advocates that member states adopt a consistent approach to the rules surrounding marketing and that regulators clarify what is and what is not permissible under reverse solicitation.
AIFMD Management Company "Manco" rules	AIFMD obliges managers to appoint a Manco to provide risk oversight. There are fears some providers are under-pricing the liability they are incurring.	The NCI advises that its members conduct rigorous operational due diligence on AIFMD Manco platforms prior to their appointment.
AIFMD depositary rules	AIFMD depositary rules could well be aligned with those of UCITS V where there is an explicit prohibition on discharging liability to the sub-custodian. If this prohibition is extended to AIFMD, some AIFMs will be paying much more for their depositaries.	The NCI would advocate clarity from regulators in the EU about whether or not they intend to extend the prohibition on depositary banks discharging liability to their sub-custodians as mandated under UCITS V to AIFMD, or at least to certain AIFMs.
Common Reporting Standard (CRS) or GATCA	This is another tax information exchange rule which could present operational challenges for fund managers.	The NCI advises its members to leverage the expertise they have accrued through FATCA compliance and apply it to the OECD's CRS.
Base Erosion and Profit Shifting (BEPS)	BEPS is a tax initiative from the OECD which seeks to clamp down on treaty shopping and toughen up on permanent establishment. This could force some managers to rework their fund structures.	The NCI would advise managers to analyse the implications BEPS will have on their businesses, and if necessary, make plans on how to attain compliance. The NCI would also urge the OECD to issue guidance as to whether AIFMs will be designated as CIVs or non-CIVs.

Regulation	Impact	NCI Recommendation
Solvency II	Solvency II will introduce capital requirements for insurers if they invest into certain asset classes. As such, this could result in insurers dis-investing from some fund managers if the capital costs are too high.	The NCI advocates regulators rethink the capital charges being imposed on insurers' underlying investments. The NCI advocates its members formulate a strategy to deal with the transparency obligations that will be associated with managing capital on behalf of insurers.
Securities Financing Transaction Regulation (SFTR)	SFTR will require financial institutions including fund managers to report details of their securities financing transactions. This could further add to reporting costs.	The NCI advocates regulators learn from some of the challenges they faced during EMIR implementation, and apply them when they enact SFTR.
European Long Term Investment Funds (ELTIFs)	ELTIFs are a new fund structure which the European Commission hopes will help increase non-bank lending into the real economy.	The NCI welcomes the ELTIFs initiative from the EU as an innovative mechanism to help return more money into the real economy.
Basel III	Basel III capital requirements will have a profound impact on hedge funds, particularly around their banking relationships, and access to financing.	The NCI advocates that hedge fund managers think very carefully about how Basel III will impact their businesses and formulate a plan to mitigate the challenges.
Financial Transaction Tax (FTT)	The FTT will introduce a levy on shares, bonds and derivatives transactions in what could result in financial institutions leaving the EU.	The NCI advises regulators look at past experiences of FTT, most notably in Sweden, before it introduces a pan-EU FTT.

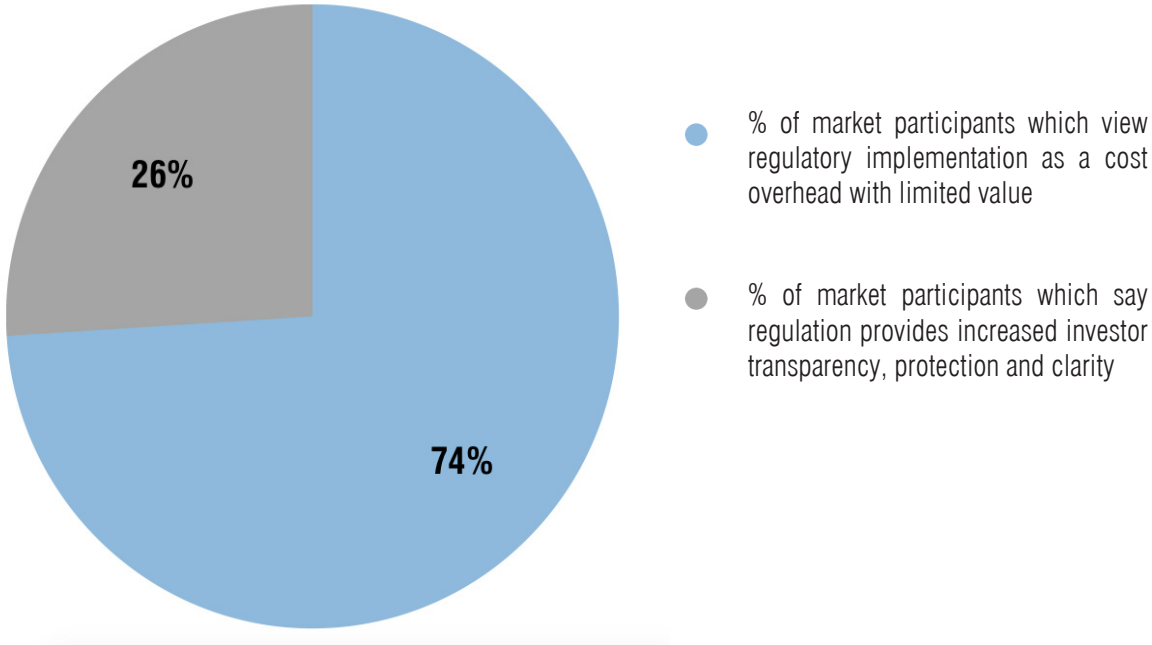
Introduction

Nearly seven years have elapsed since the financial crisis, and yet the onslaught of regulation shows no sign of abating. That regulation would be imposed after the crisis was inevitable. The extent to which it would apply to fund managers, however, caught many off-guard. An oft-repeated criticism by those working in investment management is that they did not cause the crisis nor did they require any form of government bailout, something that could not be said for the banks. Unlike banks, fund managers are not systemically important financial institutions (SIFIs) and the failure of fund management organisations during the crisis did not have a significantly material impact on the functioning of capital markets.

Regulators do not appear to have acknowledged the differences between fund managers and banks, and as such are pursuing a regulatory agenda that many feel is damaging the fund management industry and its competitiveness. A number of regulations have been introduced or are going through the motions of being introduced. These include the Alternative Investment Fund Managers Directive (AIFMD), the Markets in Financial Instruments Directive II (MiFID II), the European Market Infrastructure Regulation (EMIR), the Financial Transactions Tax (FTT), Market Abuse Regulation (MAR), Short selling regulation and the Securities Financing Transaction Regulation (SFTR). This is just in the European Union (EU).

In the US, the Dodd-Frank Act has subjected managers to additional reporting and clearing obligations, while the Foreign Account Tax Compliance Act (FATCA) requires managers globally to disclose details of US accountholders as part of the US's clampdown on tax avoidance by wealthy Americans. Global initiatives including the Organisation for Economic Co-operation and Development's (OECD) Common Reporting Standard (CRS) – a tax information exchange – will also add to the workloads of fund managers. The OECD's Base Erosion and Profit Shifting (BEPS) proposal, originally envisaged for large multinational corporations, will clamp down on treaty shopping and tighten up the provisions around permanent establishment, meaning fund managers could be forced to re-domicile their funds if authorities feel they have been structured in a jurisdiction purely to attain tax benefits.

Chart 1: The Trade off between costs and value added protection of regulation[1]



The impact of AIFMD and EMIR, and the potential impact of MiFID II have all been well-documented. Fund managers rose up to the challenges of appointing a depositary/depositary-lite, introducing curbs on remuneration, Annex IV and derivative reporting. Nonetheless, issues do remain, and regulation against the shadow banking industry, to which national competent authorities have consigned fund managers, continues to mount. This paper identifies some of the regulatory issues facing the asset management industry going forward, including AIFMD, on-going initiatives around taxation, and some of the unintended consequences around capital requirements.

[1] Northern Trust

Marketing under AIFMD: The eventual demise of reverse solicitation

Huge volumes of legal opinion have been written outlining the risks of reverse solicitation. General counsels at asset managers have been hypothesising about what constitutes reverse solicitation since the introduction of the AIFMD. Handing out a business card to an EU institutional investor could potentially fall foul of the rules; speaking publicly to a trade journal or even at a conference in the EU could set off compliance alarm bells. One lawyer once suggested that the supply of performance data to a fund database that was subscription-only could even lead to problems. Some fund managers have even been warned by general counsel against "soliciting reverse solicitation."

There are already varying interpretations of what constitutes marketing under AIFMD across different member states. Regimes in Germany, Italy and France, for example, are likely to take a tougher line on breaches than the UK or Holland. Some jurisdictions believe the point at which marketing begins is once the fund documentation is finalised, while other countries state it commences when there are initial discussions between managers and their prospective investors. The German regulator – BaFin – is reportedly scrutinising pension fund investments into fund managers and looking at whether the allocations were made through reverse solicitation. The penalties for breaching the rules include criminal sanctions and fines. Asset managers have been advised to be alert as some EU regulators may want to make public examples of firms found to be in contravention of the rules.

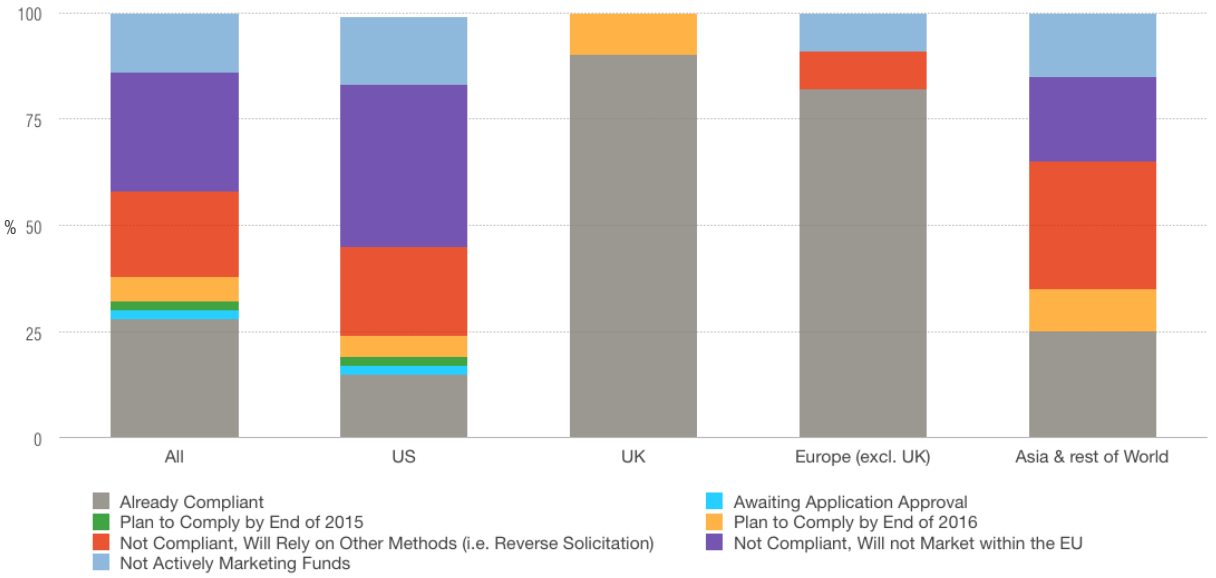
Most pressingly, a number of non-EU managers, particularly smaller ones, have found relying on reverse solicitation is not a sensible marketing strategy and has unsurprisingly failed to attract EU investors. As such, a growing number of non-EU managers are using national private placement regimes in a handful of countries where they have existing investors or strong prospects. Others are going further and launching onshore vehicles out of Dublin and Luxembourg. Meanwhile, the European Securities and Markets Authority (ESMA) said it saw no reason as to why the AIFMD marketing passport should not be extended to Jersey, Guernsey and Switzerland, jurisdictions which have made huge efforts to attain equivalence with EU laws and regulations. Nonetheless, the European Commission must pass a Delegated Act to extend the passport to these three countries. It is widely expected managers operating out of these jurisdictions will use the passport once it is offered to them if they have investors within the EU.

ESMA confirmed it had been reviewing the regulatory regimes in the US, Singapore and Hong Kong as well, but added more work needed to be done before it decides whether to extend the passport to these jurisdictions. Offshore jurisdictions such as the Cayman Islands were not considered by ESMA initially but a review will be conducted at a later date to determine whether they meet equivalence.

There are still some managers, particularly in the hedge fund space, continuing to rely on reverse solicitation (See bar chart overleaf). While the overwhelming majority of EU (including UK) managers are compliant with the Directive, a number of US and Asian hedge fund managers are not. Those managers that are not yet compliant identify AIFMD's costs and the lack of regulatory guidance as the main reasons for not being so.

Countries recommended by ESMA to receive the AIFMD passport	Jersey, Guernsey, Switzerland
Countries reviewed by ESMA with a decision yet to be finalised on the AIFMD passport	US, Singapore, Hong Kong
Countries that will likely be reviewed by ESMA going forward	Australia, Bahamas, Bermuda, Brazil, BVI, Canada, Cayman Islands, Curacao, Isle of Man, Japan, Mexico, Mauritius, South Africa, South Korea, Thailand, US Virgin Islands

Chart 2: Hedge Fund Managaer AIFMD Compliance Status by Manager Headquarters



Source: Preqin

However, an increasing number of managers more broadly now recognise reverse solicitation carries with it enormous regulatory risks and has proven ineffective. As such, the NCI expects a growing proportion of asset managers to launch AIFMs or utilise the national private placement regimes as opposed to relying on reverse solicitation.

The NCI advocates the extension of the pan-EU AIFMD passport to more third country managers in a timely fashion. The NCI advocates that member states adopt a consistent approach to the rules surrounding marketing and that regulators clarify what is and what is not permissible under reverse solicitation.

The Hidden Risk of AIFMD Management Companies (Mancos)

Article 15 of the AIFMD requires AIFMs to ensure that they have an individual carrying out risk management and oversight but who is "functionally and hierarchically" separate from the portfolio management side of the business and other operating units. Ostensibly, this is to avoid potential conflicts of interest arising. For large asset managers, fulfilling this obligation is straightforward insofar as they can simply appoint an experienced individual to a management committee where they can keep an eye on risks. Such a hire for a smaller manager is expensive. "The appointment of a hierarchically and functionally separate risk manager at a small asset management firm is very expensive and it will be difficult for small businesses," says one regulatory expert at an asset manager.

A solution to this is the appointment of an independent management company or "Manco", an outsourced platform that provides risk oversight. These entities are based in the EU (Luxembourg and Ireland), and meet the regulator's substantive presence examination criteria. This should mitigate the risk of an AIF being accused by regulators of being nothing more than a letterbox entity. A major benefit of Mancos is that they enable the fund manager to obtain a passport to market across the EU while negating the requirement for the manager to build operations inside the EU. But while Mancos are a welcome development and an effective mechanism by which managers can keep their operating costs down, there are question marks about their business practices and these have been raised by some NCI members. "I do worry that Mancos are under-priced given the potential risks and liabilities they are taking on," says one compliance head.

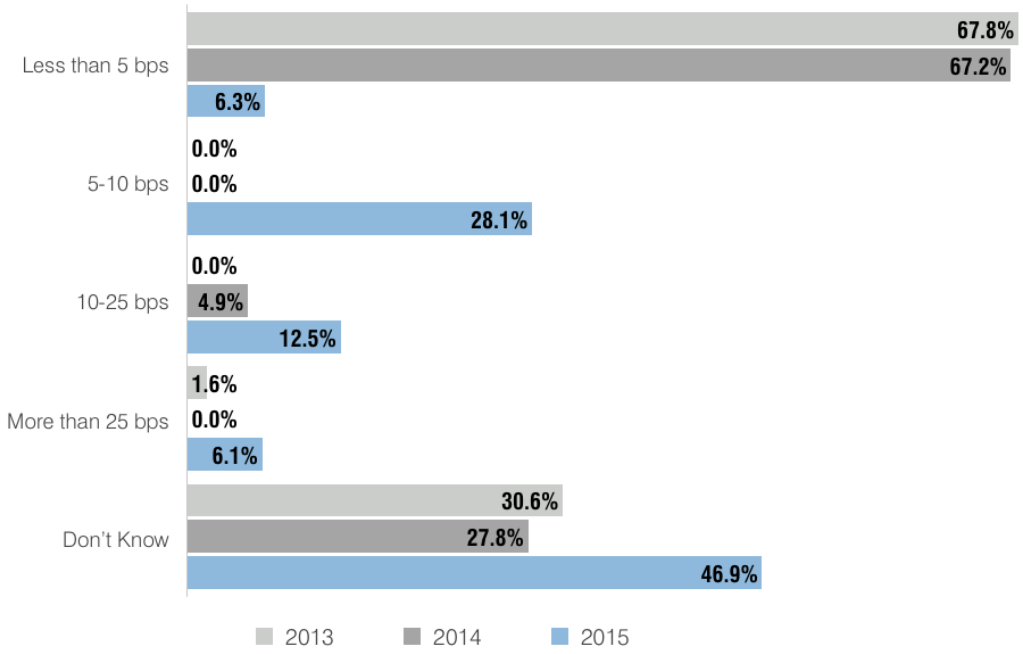
The Central Bank of Ireland (CBI) subjects Mancos to capital requirements of 0.03 per-cent of Assets under Management (AuM). Many of these organisations are not banks and do not have the capital reserves to turn to in the event of a crisis. Furthermore, a number of these Mancos have multiple business streams, and there is a risk of contagion between one business stream and the Manco. While many of these entities will possess Professional Indemnity (PI) insurance to guard against a number of eventualities, a significant credit event could pose a challenge to the continued operations of a Manco. If a Manco were to cease operating, the AIFs it supports would be unable to trade or market, and would likely suffer redemptions, particularly in volatile markets. Changing Mancos would also be time-consuming - this is something asset managers should be alert to.

The NCI advises that its members conduct rigorous operational due diligence on AIFMD Manco platforms prior to their appointment.

Depositaries – Where Next?

The appointment of a depositary/depositary-lite, an entity to provide safekeeping of assets, monitoring of cash flows, and oversight of the fund has proven to be less painful and expensive than many in the asset management industry expected.

Chart 3: Depositary Cost Levels[2]



Initial projections that the depositary-lite would only last until 2018 are likely to be proven incorrect following ESMA's announcement that it will assess regulatory equivalence for third country access to the passport on a country-by-country basis in what will be a time-consuming process. As such, national private placement could last well beyond 2018, and potentially into 2020. This will give asset managers breathing space and allow them to continue using depositary-lites instead of migrating onto a full depositary.

However, fund managers have expressed concern about the risk profile of depositaries and whether depositaries have under-priced the liabilities they are taking on. Article 21 of the Directive subjects full-scope depositary banks to strict liability for any loss or misappropriation of AIFM financial instruments at the sub-custodian level. Depositary-lites are excused from strict liability under Article 36 of the Directive. However, a number of full-scope depositaries are charging low prices because they have indemnified themselves or contractually discharged the liability for loss of financial instruments to their sub-custodians when there is an external event beyond the control of the depositary. "I feel that depositary services are under-priced for the risk that they are taking on and that worries me immensely. Many are charging fund managers a flat fee of perhaps three basis points but they are incurring enormous risks potentially," says a compliance officer at one London-based equity fund.

[2] Multifonds – Part 4: The Impact of AIFMD and Convergence Survey

These discounted depositary rates might only be a temporary phenomenon. This is because UCITS V explicitly prohibits depositary banks from discharging liability for loss of financial instruments to the sub-custodian level, including at market infrastructures such as Central Securities Depositories (CSDs). It is well-documented that regulators are seeking to align UCITS with AIFMD, and any future re-writes of AIFMD could extend this prohibition on the discharge of liability to depositaries working with AIFMs. While UCITS are restricted in their investments to vanilla strategies and markets, AIFMs have far more flexibility and are permitted to invest in riskier asset classes. If there is UCITS and AIFMD alignment on depositaries, the price of depositary services for AIFMs could rise exponentially in due course as they will be less comfortable taking on liability for higher risk assets or exotic markets. UCITS managers could also face much higher depositary costs because of UCITS V.

Regulators have yet to confirm or deny their intentions to align AIFMD and UCITS' depositary rules. A number of market participants doubt this will occur. However, UCITS VI is likely to introduce a pan-EU depositary passport enabling a manager to appoint a depositary outside of the jurisdiction the fund is based. A pan-EU depositary passport would imply there are harmonised pan-EU depositary standards, and there is no reason why strict liability would be excused from this. One executive at a depositary bank says that while it is unlikely the prohibition on discharging liability would be extended to depositaries of alternative funds, it could be imposed on depositaries servicing non-UCITS retail funds subject to AIFMD.

The NCI would advocate clarity from regulators in the EU about whether or not they intend to extend the prohibition on depositary banks discharging liability to their sub-custodians as mandated under UCITS V to AIFMD or at least to certain AIFMs.

GATCA

The OECD's Common Reporting Standard (CRS) – dubbed the Global FATCA or "GATCA" – is an automatic tax information exchange agreement that has been agreed (at time of writing) between approximately 90 countries (See list of some examples below). CRS will require data on accountholders including balances, interests, sales proceeds and dividends to be disclosed by financial institutions to various tax authorities at the signatory governments. It will also create a uniform standard of due diligence to be undertaken on clients by financial institutions. This will ensnare fund managers and could result in overlap with other pre-existing tax information sharing agreements. Firms recognise CRS will mirror US FATCA and its UK counterpart – the so-called "Son of FATCA" - in many areas. "FATCA was so complex and a huge pain. Understanding what it meant, who was affected, and how we avoid non-compliance was an enormous undertaking. Understanding the rules rather than implementing the rules per say was the biggest challenge," explains one manager.

GATCA Signatories:

September 2017	Anguilla, Argentina, Belgium, Bermuda, British Virgin Islands, Cayman Islands, Colombia, Croatia, Curaçao, Cyprus, Czech Republic, Denmark, Estonia, Faroe Islands, Finland, France, Germany, Gibraltar, Greece, Guernsey, Hungary, Iceland, India, Ireland, Isle of Man, Italy, Jersey, Korea, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Mauritius, Mexico, Montserrat, Netherlands, Norway, Poland, Portugal, Romania, San Marino, Seychelles, Slovak Republic, Slovenia, South Africa, Spain, Sweden, Turks & Caicos Islands, United Kingdom
September 2018	Albania, Aruba, Australia, Austria, Canada, Chile, Costa Rica, Ghana, Indonesia, New Zealand, Switzerland

CRS will be a significant undertaking, and it is coming into fruition soon. The early adopters will commence the collection of this data in 2016 with information being exchanged as of 2017. Perhaps one of the best mechanisms by which managers can prepare for the CRS is to ensure their pre-existing US and UK FATCA reporting solutions are holistic and can be adapted to the challenges and nuances associated with the CRS.

The NCI advises its members to leverage the expertise they have accrued through FATCA compliance to the OECD's CRS.

[3] OECD

Base Erosion and Profit Shifting (BEPS)

BEPS is another OECD-led initiative, which has seemingly caught many market participants and experts off-guard by its pace of implementation. First discussed in 2014, BEPS could be implemented as early as 2016 or 2017. There is strong political backing for BEPS and an action plan will be unveiled to the G20 Finance Ministers in Lima, Peru in October 2015. While the OECD cannot introduce legislation on its own, national authorities can heed its advice, and pass their own laws. BEPS comprises 15 action plans, and several apply to asset managers. Perhaps one of the most pressing is Action 6 designed to curtail treaty shopping or treaty abuse whereby multinational corporations will structure their businesses in jurisdictions where there are generous tax treaties. Another crucial aspect of BEPS is its tightening up of "Permanent Establishment."

While BEPS is aimed at multinational giants, fund managers are invariably caught in the cross-fire. A number of managers will structure their funds in tax-efficient jurisdictions such as Luxembourg, Ireland, Cayman Islands, British Virgin Islands, Bermuda, Jersey or Guernsey, to attain tax neutrality for a global pool of investors. Any fund domiciled in tax efficient jurisdictions benefiting from a reduced taxation income or dividend payments will be affected if there is little or no substantive link to that jurisdiction – e.g. no or few investors or investments in that jurisdiction. Firms will therefore have to demonstrate they have meaningful substance so as to avoid scrutiny over their businesses' tax arrangements. This might entail having key personnel based in these jurisdictions to satisfy tax authorities.

Different types of fund vehicles are going to be afforded different tax treatment under BEPS. BEPS will give Collective Investment Vehicles (CIVs) or regulated entities such as UCITS better tax treatment than non-CIVs, which will include alternative asset managers – i.e. hedge funds and private equity. The OECD has yet to confirm whether AIFMs will be deemed CIVs or non-CIVs. Many argue that AIFM structures are indeed regulated under AIFMD and should be designated as CIVs when the rules come into play.

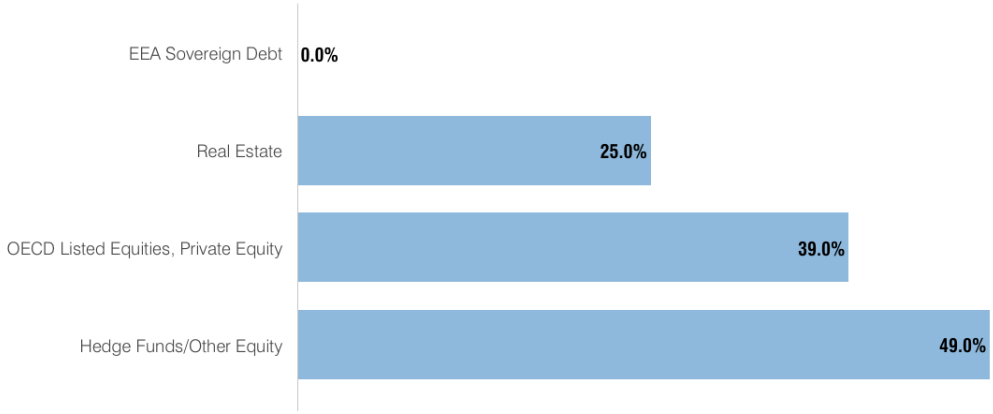
Countries are introducing their own variants of BEPS through legislation, most notably the UK. The UK Finance Bill contains provisions on the Diverted Profits Tax, which will force multinationals (including fund managers) to pay 25 per-cent taxation on any profits deemed to have been passed through into lower tax jurisdictions. The rules are not just confined to UK managers but can apply to non-UK parent companies with UK subsidiaries. Other countries are following suit, such as Australia. The big risk for managers is if a number of countries pass divergent tax rules leading to widespread arbitrage and uncertainty.

The NCI would advise managers to analyse the implications BEPS will have on their businesses, and if necessary, make plans on how to attain compliance. The NCI would also urge the OECD to issue guidance as to whether AIFMs will be designated as CIVs or non-CIVs.

Solvency II

Solvency II is an EU-led initiative due to be implemented in January 2016. It is designed to prevent another taxpayer bailout of an insurance company following the spectacular rescue of American International Group (AIG) by the US government in 2008. It is primarily aimed at insurers but its knock-on effects will be felt profoundly by fund managers of all asset classes. The Directive subjects insurers to a capital adequacy regime whereby the insurer must hold capital corresponding to the perceived riskyness of its underlying investments, a criterion that has been laid out by regulators.

Chart 4: Solvency II Capital requirements by Asset class:



If an insurer has exposure to hedge funds or "other equity", it is subject to a capital charge of 49 per-cent of that investment; for private equity or OECD listed equities, the insurer must hold 39 per-cent in capital; real estate subjects the insurer to a capital charge of 25 per-cent; while European Economic Area (EEA) sovereign debt has no capital charge whatsoever. The latter provision has predictably been subject to much industry criticism given the recent market volatility in several member states, some of which have been subjected to repeat bail-outs. Many have argued these capital requirements are too high when applied to asset managers such as hedge funds and could impede diversification at insurers. Some worry it could even result in insurers dis-investing from certain asset classes if the capital charges are too high.

However, if managers provide position level data, which in turn will be supplied to regulators by insurers, this can enable insurers to lower their capital charges. Insurers will be required to supply data on a timely basis to regulators. Supplying this highly forensic data to insurers will be an operational challenge for managers, and many have expressed alarm they will struggle to deliver the relevant information accurately and on time. Some managers are nervous about the risk of proprietary data leakage, which could facilitate short-squeezes or copycat trading. The problem could be particularly pertinent for funds of funds running assets on behalf of insurers. Many of these funds of funds could struggle to obtain the prerequisite data from their own underlying managers. Nonetheless, if managers want to run capital on behalf of insurers, it is advised they supply the data.

The NCI advocates regulators rethink the capital charges being imposed on insurers' underlying investments. The NCI advocates its members formulate a strategy to deal with the transparency obligations that will be associated with managing capital on behalf of insurers.

Securities Financing Transaction Regulation (SFTR)

The Securities Financing Transaction Regulation (SFTR) could have a profound impact on financial institutions including fund managers and may be implemented as early as 2016. SFTR has been mirrored to an extent on EMIR and will require firms to reports details of their securities financing transactions (which include repos, reverse-repos, securities lending and borrowing, derivative transactions such as total return swaps, collateral swaps and liquidity swaps, etc) to trade repositories. That SFTR looks likely to require firms to report securities financing transactions in a manner similar to how exchange traded derivatives (ETDs) and over-the-counter derivatives (OTCs) are reported under EMIR will undoubtedly frustrate managers given the challenges many had with the dual-sided reporting demanded under EMIR. Dual-sided reporting is when both counterparties to a trade need to report details of that trade.

A number of firms struggled to agree with their counterparties about the generation of the Unique Transaction Identifier (UTI), the alphanumeric code designed to allow trade repositories to reconcile reported transactions under EMIR. The inability to agree which counterparty generated the UTI assigned to the trade meant both counterparties generated UTIs, which were often different. This meant trade repositories were unable to reconcile many of the OTC and ETD trades reported to them. This in turn resulted in regulators being unable to spot build-ups in systemic risk in the derivatives market based on the data they received. Regulators should take note of the challenges associated with dual-sided reporting and implement single sided reporting under SFTR. In fact, the Committee on Payments and Market Infrastructures (CPMI) and the International Organisation of Securities Commissions (IOSCO) have asked for public comments on UTIs following publication of its recent report – "Harmonisation of the Unique Transaction Identifier (UTI)". It is hoped this will lead to more harmonisation in derivative trade reporting.

SFTR could also require AIFMs and UCITS to provide information about their securities financing transactions and re-hypothecation agreements to investors. This could be an operational headache. There is a strong possibility that this restriction on re-hypothecation practices could be a sign that European regulators intend to further clamp-down on the practice.

The NCI advocates regulators learn from some of the challenges they faced during EMIR implementation, and apply them when they enact SFTR.

European Long-Term Investment Funds (ELTIFs)

ELTIFs, which will come into play in December 2015, are an ambitious, well-meaning attempt by European regulators to reduce the real economy's reliance on traditional bank lending, by encouraging an increase in non-bank lending. ELTIFs, which will be structured as AIFMs although made available to both retail and institutional allocators, will provide exposure to illiquid assets such as infrastructure, real estate and private loans. They will be regulated under AIFMD although subject to more investment restrictions. 70 per-cent of the portfolio can be invested in long-term investments, and no more than 10 per-cent can be exposed to a single infrastructure project, although 30 per-cent must be placed in highly liquid assets which meet UCITS eligibility criteria. This is to enable diversification.

Regulators have told managers they would prefer it if they did not allow redemptions so as to guarantee long-term investments. However, the decision to allow for redemptions lies solely with the manager. Most expect investors to be locked into ELTIFs for the duration of the fund's life-cycle. Some experts predict ELTIFs will be a success, with a particular appeal for small- to mid-sized pension funds and insurers lacking the scale and sophistication to invest directly into infrastructure or credit funds. However, they do carry risks. Some are concerned about retail investors being exposed to illiquid assets and being unable to redeem their money for many years. As such, it is crucial that managers contemplating launching an ELTIF ensure their retail investors are fully informed of the risks.

At present, there seems to be muted interest in ELTIFs. Lawyers report very few managers in the private equity world are launching such products. Smaller private funds cater for only a handful of institutional investors and do not possess the internal infrastructure to meet the requirements of thousands of retail clients. There are a number of restrictions around ELTIFs. A paper by Clifford Chance highlights ELTIFs cannot engage in short-selling, take excessive leverage, have direct or indirect exposures to commodities, or engage in securities lending or repurchase agreements if it affects more than 10 per-cent of the ELTIFs' assets. Nonetheless, regulators are keen to promote ELTIFs and it forms a major component of the Capital Markets Union (CMU) project currently underway at the European Commission. However, managers should exercise caution. European Social Entrepreneurship Funds (EUSEFs) and European Venture Capital Funds (EUVECAs) have not been a resounding success (although this might change), and there is a possibility ELTIFs might follow a similar trajectory.

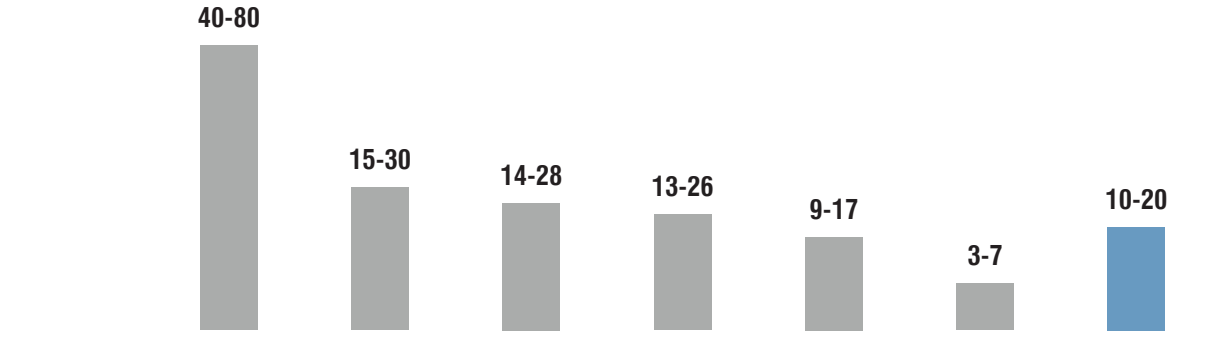
The NCI welcomes the ELTIFs initiative from the EU as an innovative mechanism to help return more money into the real economy.

Basel III

Basel III capital requirements may be directed at the banks but are going to have a major impact on the asset management industry, particularly hedge funds. Basel III Liquidity Coverage Ratios (LCR) are designed to ensure financial institutions can manage short-term liquidity disruptions by requiring them to hold high quality liquid assets to survive a 30-day market stress event. Meanwhile, the Net Stable Funding Ratio (NSFR) is designed to prevent banks from suffering from liquidity mismatches and relying excessively on short-term funding. Excess hedge fund cash at banks is deemed to be short-term because it can be withdrawn at short notice during bouts of market stress. As such, banks must hold more capital to minimise this risk. A number of banks are now telling hedge fund clients to park their cash elsewhere, with Money Market Mutual Funds likely to be one of the obvious candidates.

Prime brokers will be forced to restrict hedge fund financing and some banks are already culling relationships with hedge funds deemed to be unprofitable or unlikely to grow. Others have simply increased fees to levels that are unsustainable for managers. Reports suggest that any restrictions on financing will have a negative impact on the returns and performance of illiquid or leveraged hedge fund strategies in particular. A study in 2012 by the prime brokerage business at Barclays estimated the average hedge fund's returns could drop between 10 basis points and 20 basis points because of this financing dearth. Some strategies will feel the pain harder than others. Fixed income arbitrage, which is leveraged 13 times its net asset value (NAV) on average could endure a fall in performance of between 40 basis points and 80 basis points, according to Barclays.

Chart 5: Potential impact of financing rate increases on returns of different HF Strategies, bps



Source: HedgeFund.net, Hedge Fund Research, Greenwich Alternative Investments, Strategic Consulting Analysis

The retreat of banks could lead to other market participants providing financing to hedge funds. This could include private equity firms, which are sitting on enormous piles of dry power and are not subject to Basel III capital rules. However, these institutions might not possess the operational infrastructure to provide financing, a point made by prime brokers. Irrespective, Basel III will have major ramifications for hedge funds, and will undoubtedly ramp up the cost of business.

The NCI advocates that hedge fund managers think very carefully about how Basel III will impact their business and formulate a plan to mitigate the challenges.

Financial Transaction Tax

First proposed in 2011, the EU's Financial Transaction Tax (FTT) has been on the discussion table ever since. Buoyed by public anger over the government bail-outs of the banks, the FTT would apply a 0.1 per-cent levy on shares and bond transactions. It would also impose a 0.01 per-cent tax on derivatives transactions. Derivatives trades often have a long transactional chain meaning that the 0.01 per-cent tax would probably be closer to 0.1 per-cent. It will apply to all transactions where at least one party is based in the EU. This has led to criticism that the rules are extraterritorial. At present, 11 EU countries including France and Germany intend to introduce or have introduced an FTT although there is pressure to make it an EU-wide levy subject to member state discretion, something which the UK has strongly resisted.

Countries in favour of FTT	Germany; France; Italy; Austria; Belgium; Estonia; Greece; Portugal; Slovakia; Slovenia; Spain

The implications of an FTT are well-documented. Financial institutions which trade high volumes will be impacted and this could lead to liquidity drying up. Meanwhile, a levy on derivatives could discourage legitimate hedging practices thereby leading to build-ups of risk. The compliance costs associated with recordkeeping and capturing all of the trading data will be substantial, a point made in a report – "Financial Transaction Taxes: Practical lessons from a strategic solution roll-out" – published by GBST and Deloitte.

A pan-EU FTT would be catastrophic for major financial centres within the EU. History has demonstrated financial transaction taxes can have adverse consequences. In 1984, Sweden introduced a 0.5 per-cent tax on the purchase and sales of equity securities, and promptly doubled the charge two years later. This led to Swedish financial institutions relocating, predominantly to London. The tax in Sweden was scrapped in the early 1990s although the long-term damage was done. In countries where FTT has taken effect, such as Italy, there have reports of huge drops in trading volumes. Should the EU pursue this path, it is very possible financial institutions could well relocate to the US or Asia-Pacific. However, the EU is sharply divided over the FTT and this is unlikely to be resolved soon.

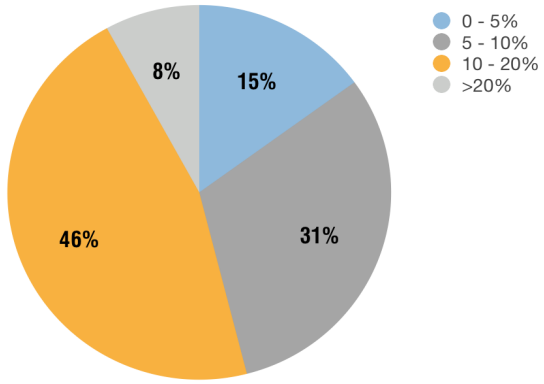
The NCI advises regulators look at past experiences of FTT, most notably in Sweden, before it introduces a pan-EU FTT.

Conclusion

The regulation that followed the financial crisis has had a huge impact on fund managers' operations. A number of managers who historically ran lean operations have had to ramp up the number of hires in operations and compliance. The proposed prohibition on managers using equity commissions to pay for sell-side research under MiFID II – should it materialise – will also add massive costs to the industry. For some, the cost of doing business today has become excessively high, and this risks stifling the emergence and development of promising managers in what has historically been a highly competitive and innovative industry.

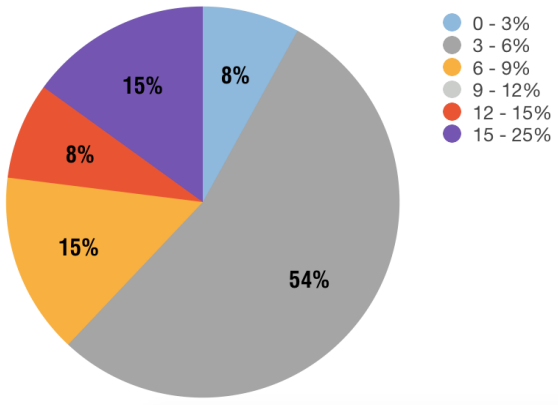
The NCI conducted a small survey of its members to highlight the added cost and time burdens associated with regulation.

Chart 6: Time spent on regulation by management (% of total)



This small survey of NCI members found that 46 per-cent spent around 10 per-cent to 20 per-cent of management time dealing with regulatory compliance. 8 per-cent spent in excess of 20 per-cent of management time on regulatory matters. This is a significant amount of time for small to mid-sized asset management companies to be devoting to regulatory matters.

Chart 7: Cost of regulation as a proportion of operating costs (% of total)



The survey on the previous page illustrates the cost burden regulations are having on the asset management industry. 54 per-cent of surveyed NCI members believed the costs of regulatory compliance accounted for between 3 per-cent to 6 per-cent of their overall operating costs. 15 per-cent estimated the costs of regulation comprised between 15 per-cent and 25 per-cent of their overall operating costs. Meanwhile 8 per-cent of respondents said regulation accounted for less than 3 per-cent of operating costs. This all adds to the cost of running a viable business and will discourage some talented individuals from establishing asset management firms.

Such an outcome reduces the availability of manager choice for investors at a time when returns are hard to come by. For investors such as public sector pension plans – many of whom are running significant deficits – manager choice and diversity are central to attaining returns for underlying shareholders. Furthermore, by preventing the development of smaller to mid-sized managers through excessive regulation, regulators risk forcing institutional investors to concentrate their assets into a handful of large portfolio managers rather than enabling them to attain diversification. This could expose a number of high-profile institutional investors to increased levels of concentration risk. If one of those managers were to enter into a severe credit event, those investors could be seriously affected.

Regulation must be sensible and it must be proportionate. Most importantly, it needs to serve the purpose it was intended to serve, and that is to protect investors and guard against systemic risk. Managers are going to be subject to further regulation and this is going to add to the already high cost of business inside the EU, and there are question marks as to whether this is conducive to regulators' stated objectives.

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www.newcityinitiative.org
@NCityInitiative

New City Initiative, Third Floor Princes Court, 7 Princes Street, London, EC2R 8AQ