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Regulatory Architecture

A proactive and sustainable approach to regulatory management

30th September 2015

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Principal regulatory challenges

1. **Volume of regulation**
2. **Material impact**
3. **Accountability**
4. **Decentralised or federated business models**

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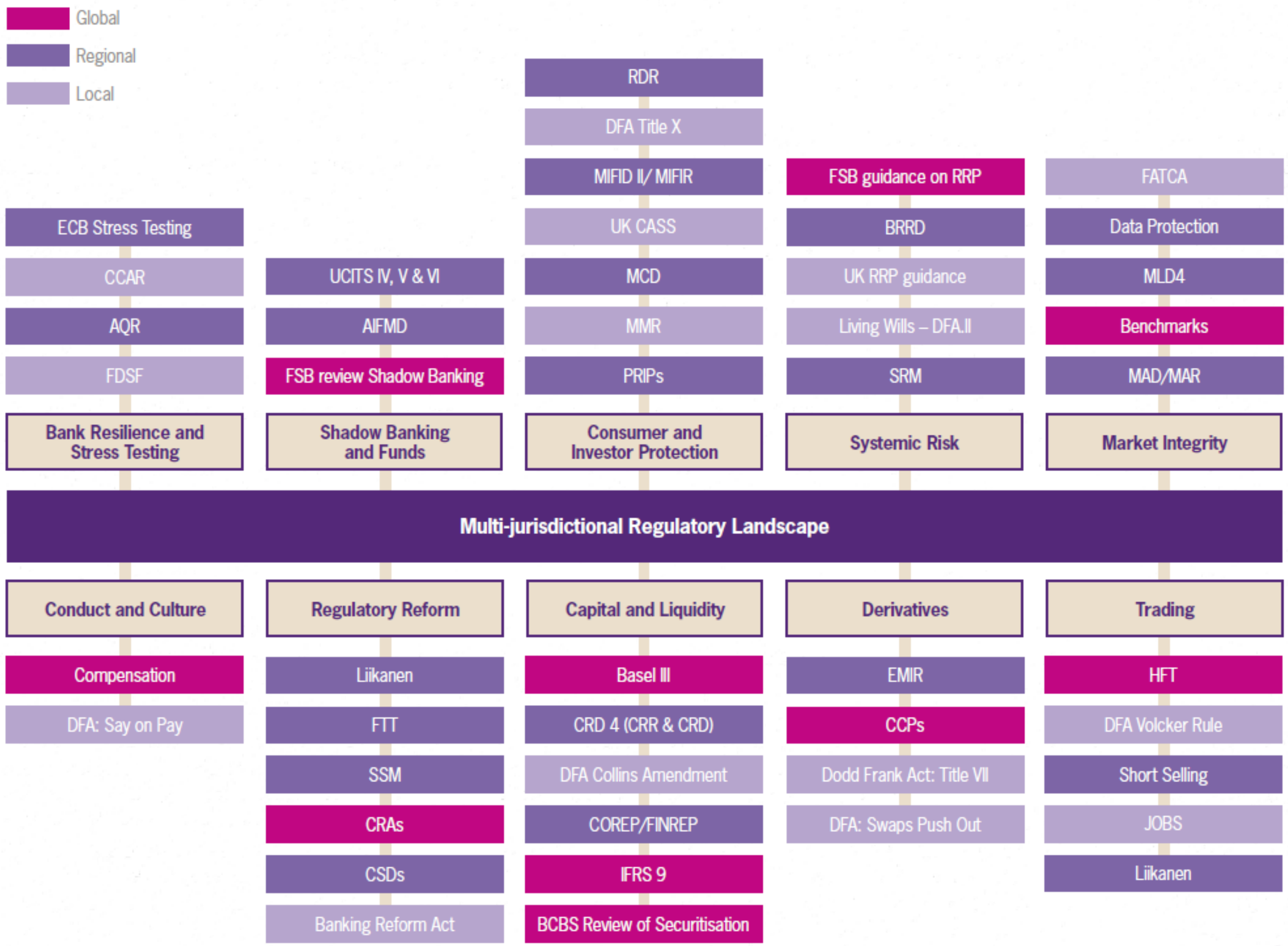
Multi-jurisdictional malaise



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Why implement a regulatory architecture?

1 Regulatory pressures will continue

Regulatory pressures will continue to intensify. As volume, complexity and reporting obligations increase, a proactive approach to management and mitigation will be essential.

2 Federated approaches are no longer sustainable

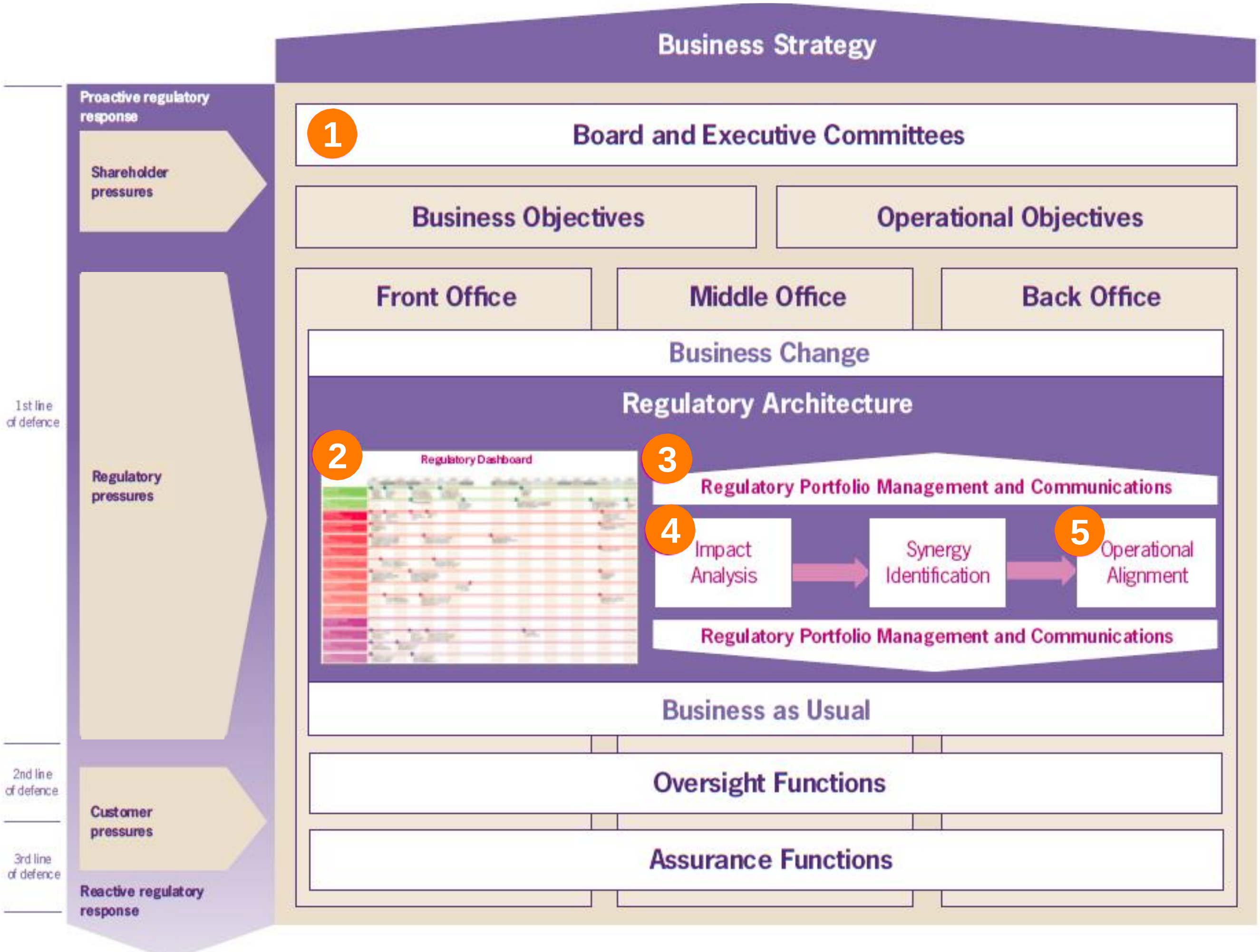
Federated organisational, project and reporting structures have a track record of failure. Collaborative and firm-wide approaches to regulatory change and management must underpin a more proactive approach.

3 Mandatory requirements will abide

Despite the demand for more proactive approaches, mandatory requirements will abide. Compliance teams will be increasingly occupied with mandatory monitoring and reporting activities, leaving little time for proactive management of future regulatory issues.

> "Proactive organisations that establish a solid governance framework capable of linking business and regulatory strategy will be those that succeed."

Managing the regulatory spaghetti



1. Governance and accountability
2. Single view dashboard
3. Regulatory portfolio management
4. Impact analysis
5. Operational alignment

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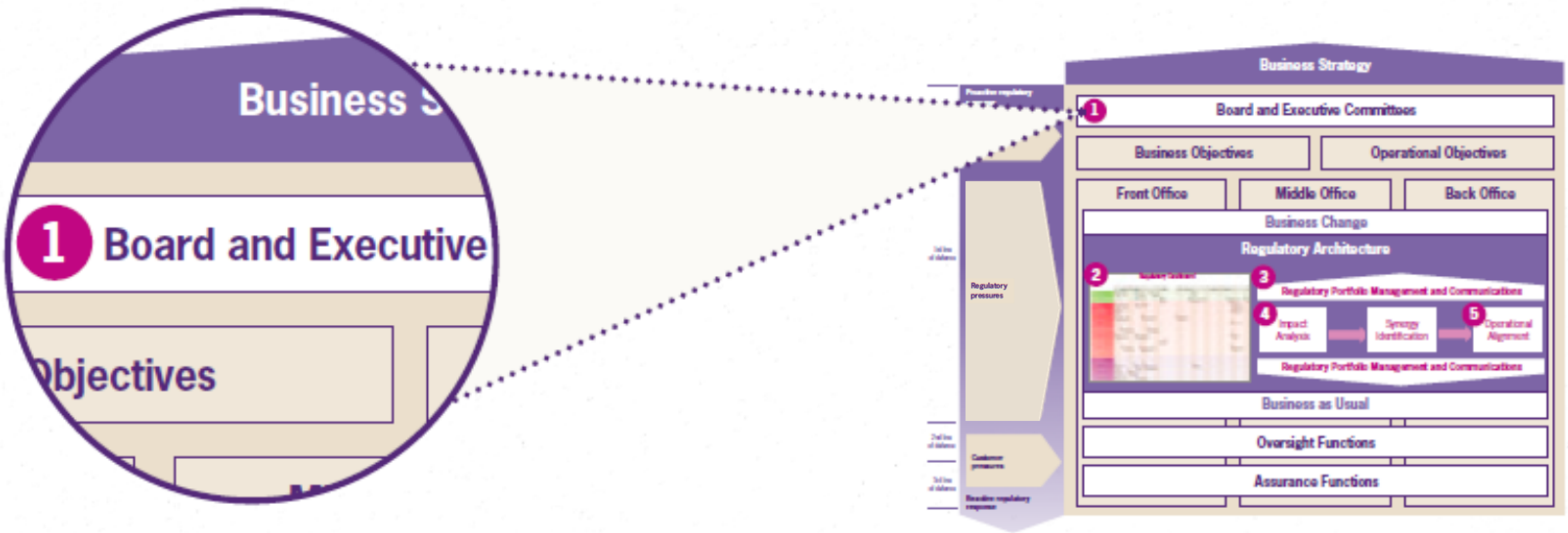
Governance and accountability



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Governance and accountability

1
Strategic alignment

Firms must reassert authority over their business strategies. Ensuring strategic objectives are informed, and not driven, by the regulatory agenda.

Key steps:

- Review business strategy to ensure regulatory alignment
- Establish process by which regulatory developments inform future strategic decisions
- Embed regulatory expertise in strategic definition phases

2
Regulatory liaison

Firms must proactively engage with regulatory bodies, both to develop clearer understanding of intent and to play an active role in future regulatory developments.

Key steps:

- Appoint a central regulatory liaison
- Establish a regular communication medium with regulatory bodies
- Influence legislative decision-making

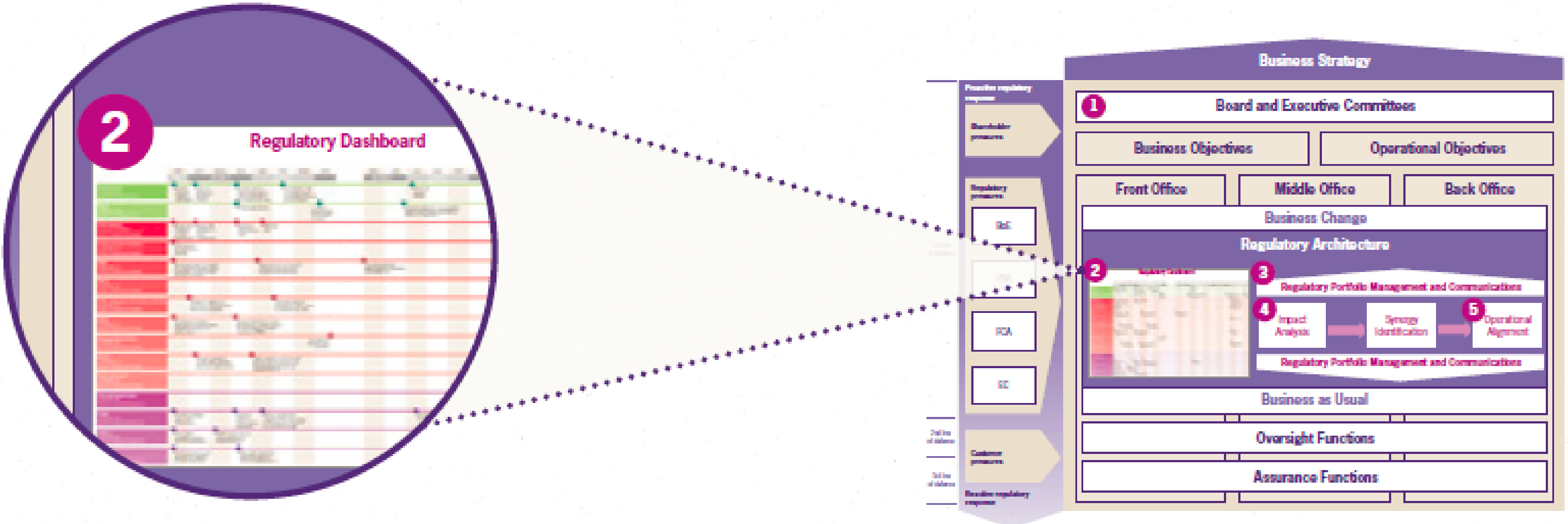
3
Informed decision-making

Establishing a framework by which regulatory matters countenance C-level decision-making is critical.

Key steps:

- Embed expert regulatory presence at Board and Executive Committee level
- Fortify management information to support risk governance and business decision-making

Single view dashboard



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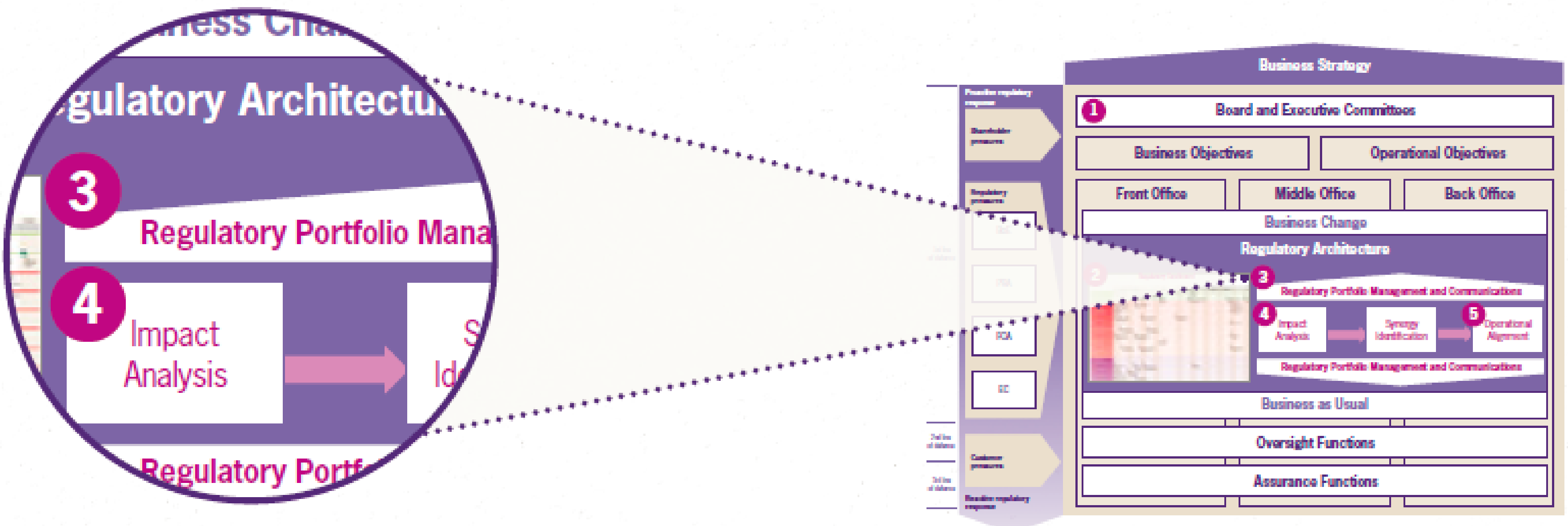
Single view dashboard

Core components of Grant Thornton's single view dashboard include:

- **Horizon scanning -** proactive regulatory monitoring allows firms to develop a deep understanding as legislation evolves through the development cycle, from consultation to implementation.
- **Understanding intent -** understanding the intent of rule-makers helps organisations to interpret rules and manage their practical application.
- **Engage the regulator -** engaging with the regulator during the consultation phase is a proven method to help play a role in the development of regulation and mitigate against particularly onerous proposals.
- **Golden source of information -** a central hub for regulatory information and knowledge ensures regulatory change is transparent and coordinated. Functional alignment and consistent rules and requirements mapping methodologies promote collaborative change.

Regulatory portfolio management



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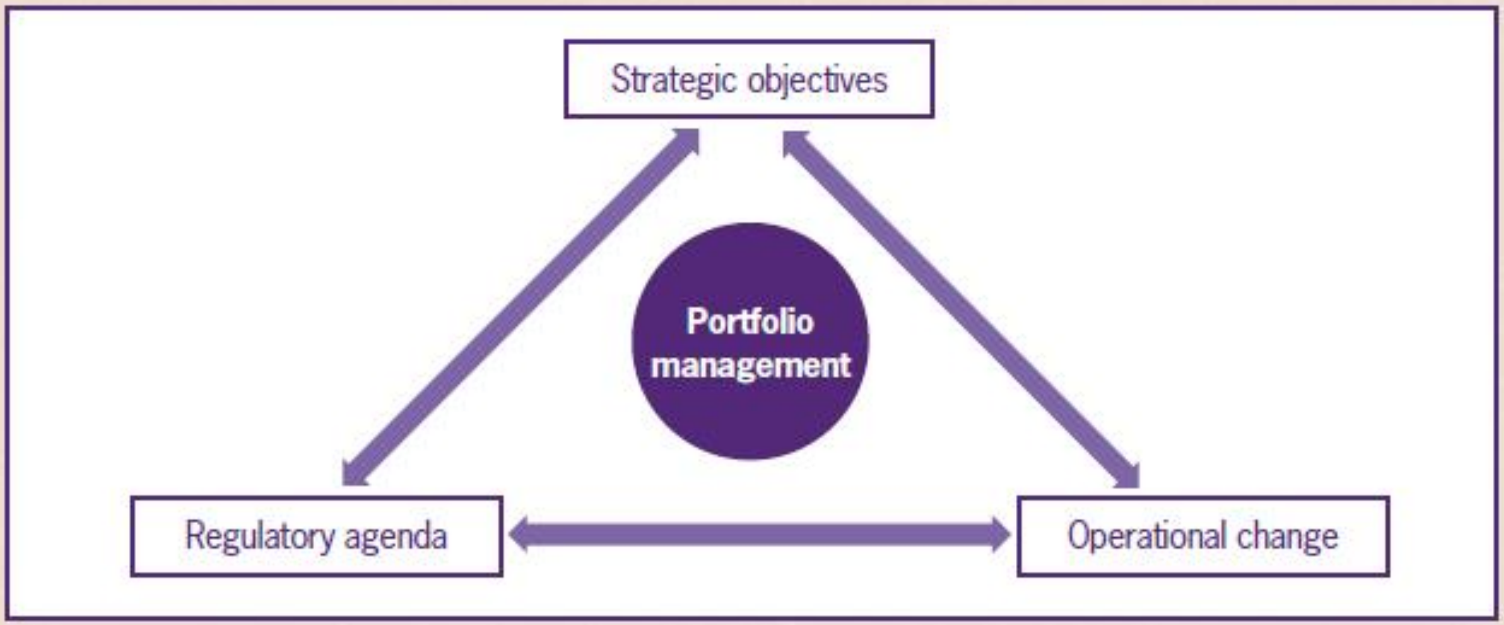
Regulatory portfolio management

Integrate business, change and regulatory objectives

Coordinated portfolio management should be applied to items within both the regulatory and change agendas to optimise delivery of strategic objectives.



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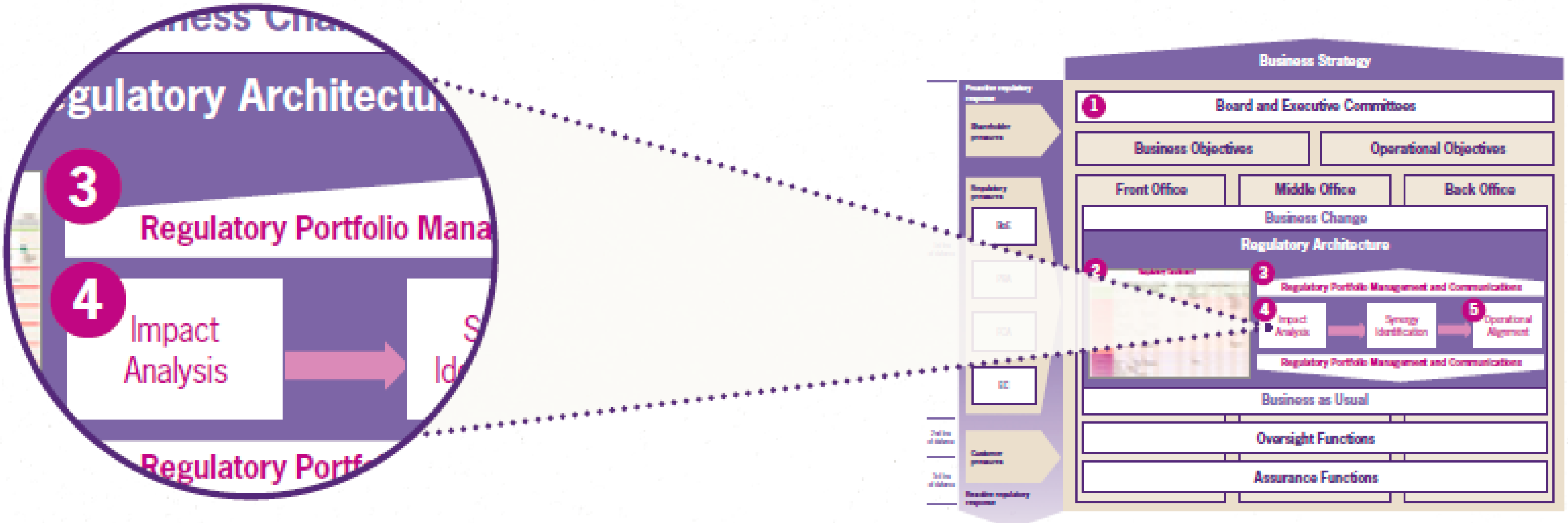
Impact analysis



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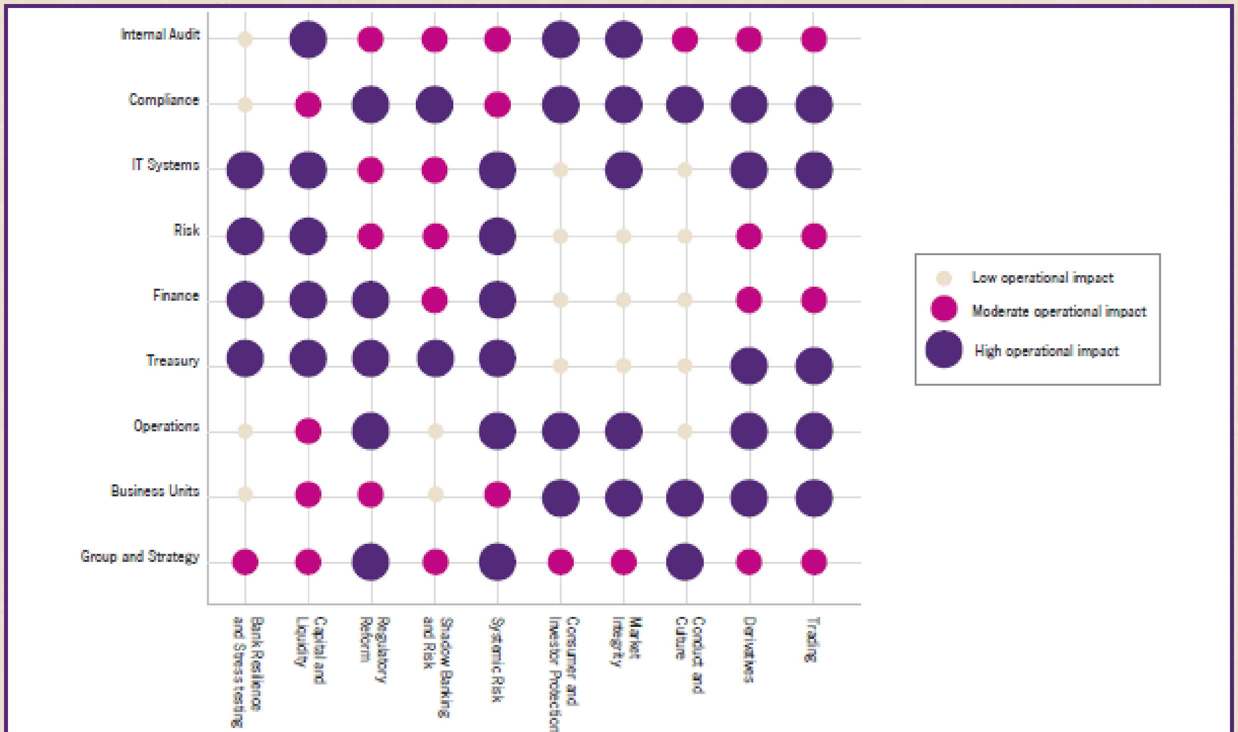
Impact analysis

Functionally aligned operational impact assessment

The complimentary components of Grant Thornton's *Regulatory Architecture* allow *Regulatory Analysis* teams to perform fully informed, functionally aligned analysis of operational impacts. As the regulatory agenda extends its cross-functional influence, the necessity to fully understand the scope and extent of operational impact become imperative.



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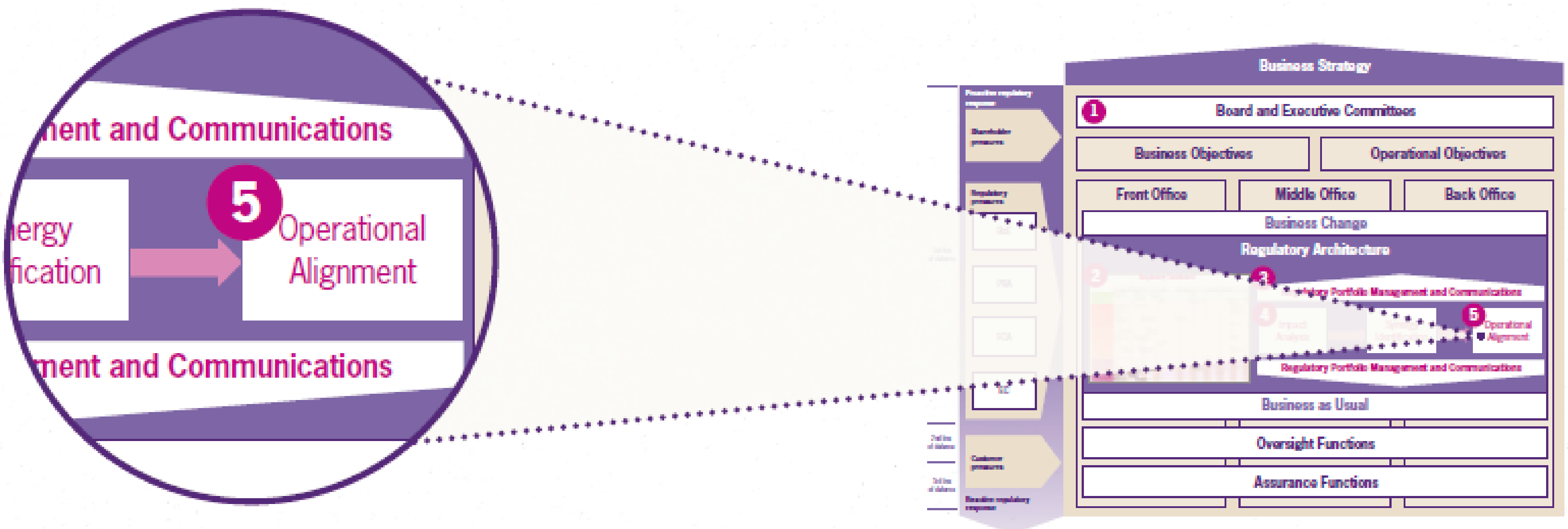
Operational alignment



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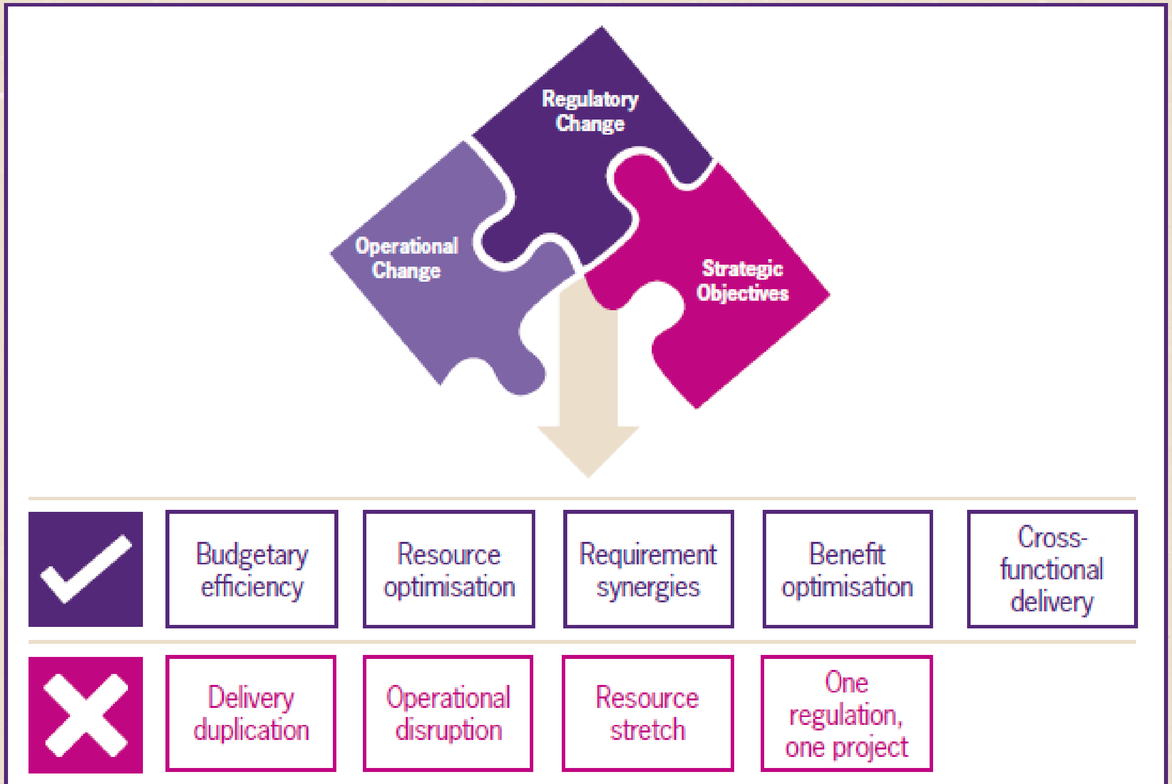
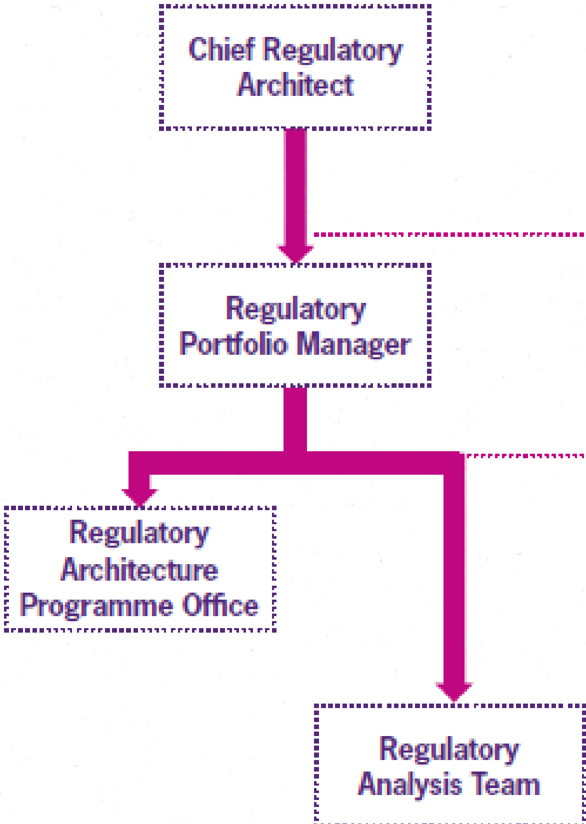
Operational alignment

Operational alignment

Alignment of operational and regulatory change delivers multiple benefits and mitigates against operational and budgetary inefficiencies.



Regulatory architecture - structure



Role and responsibility	Primary interactions	
• Principal regulatory oversight • Regulatory liaison • Board and exco reporting • Regulatory communications	• Board • Excos • Regulators • Head of change • Head of compliance	• Head of risk • Legal • Finance • Operation heads
• Regulatory portfolio management • Change portfolio interface • Stakeholder management • Synergy alignment	• Change managers • Business managers • Compliance	• Risk • Functional heads
Regulatory Architecture PO: • Regulatory portfolio management • Prioritisation and scheduling • Demand management • Synergy alignment	• Business change PMO's • Technology change PMO's • Change managers	• Business managers • Compliance • Risk
Regulatory Analysis Team: • Regulatory impact analysis • Horizon scanning	• Chief regulatory architect • Regulatory portfolio manager	• Regulatory architecture PMO • Regulators

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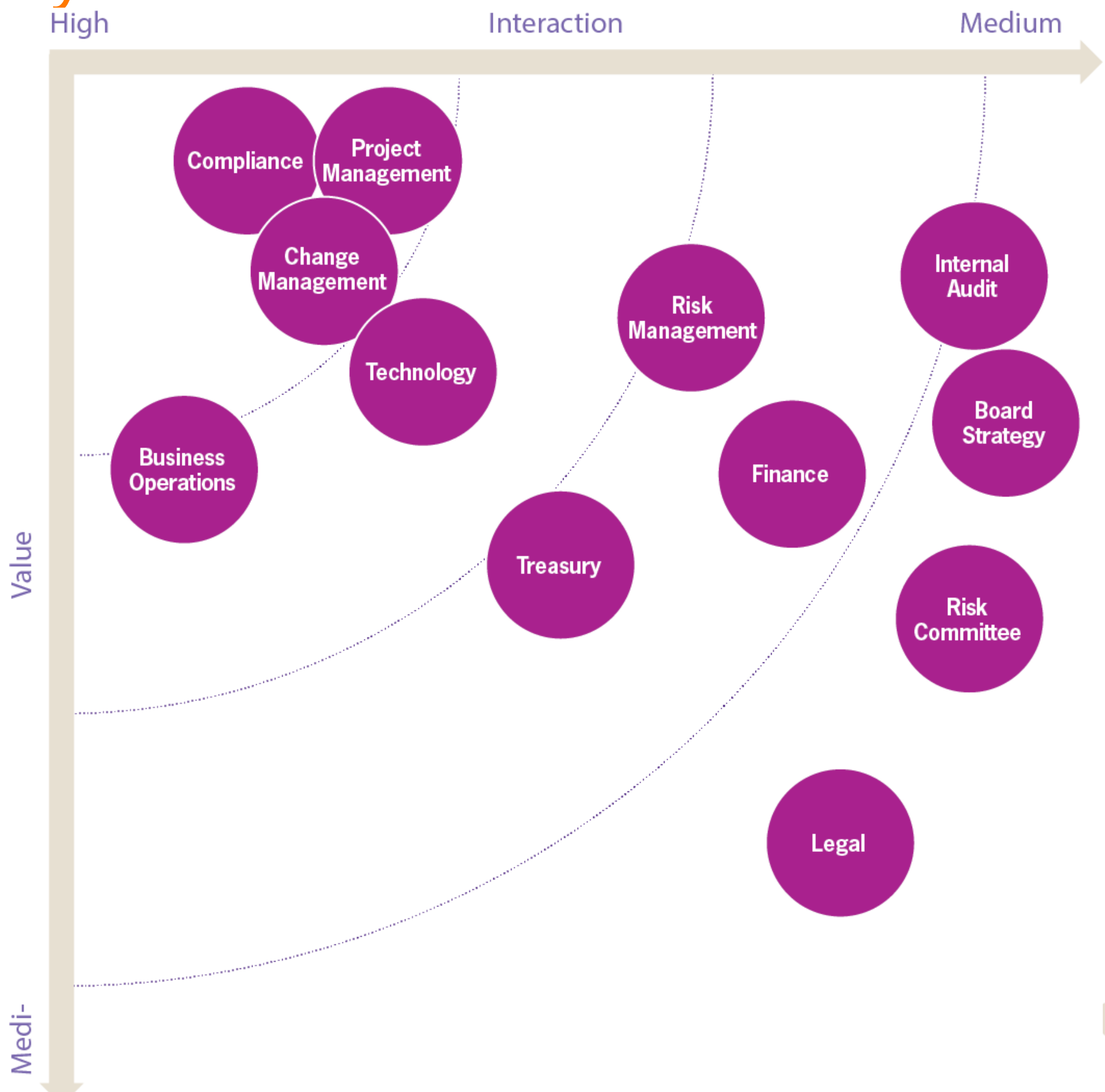
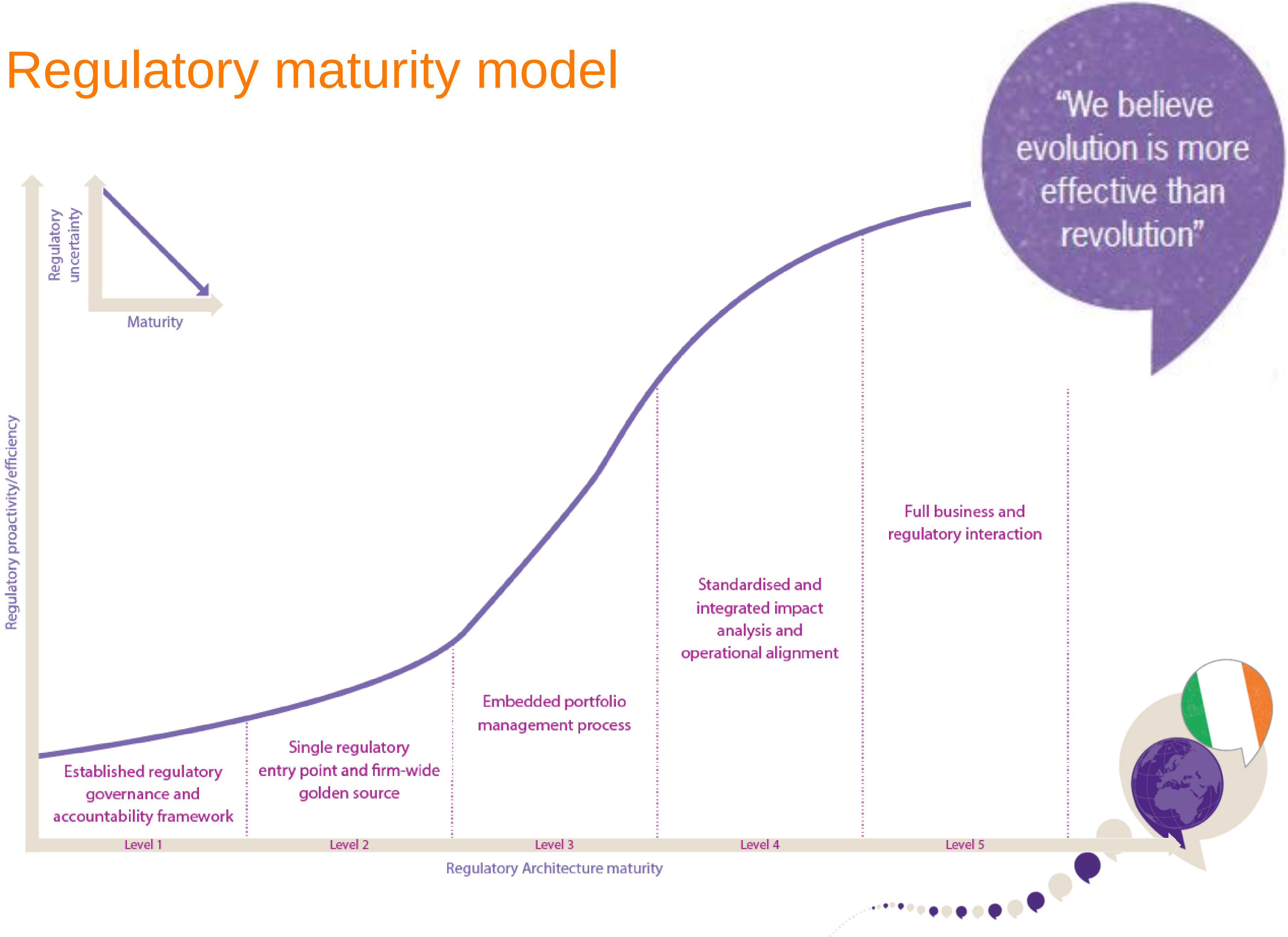
Regulatory architecture - interaction



Regulatory maturity model



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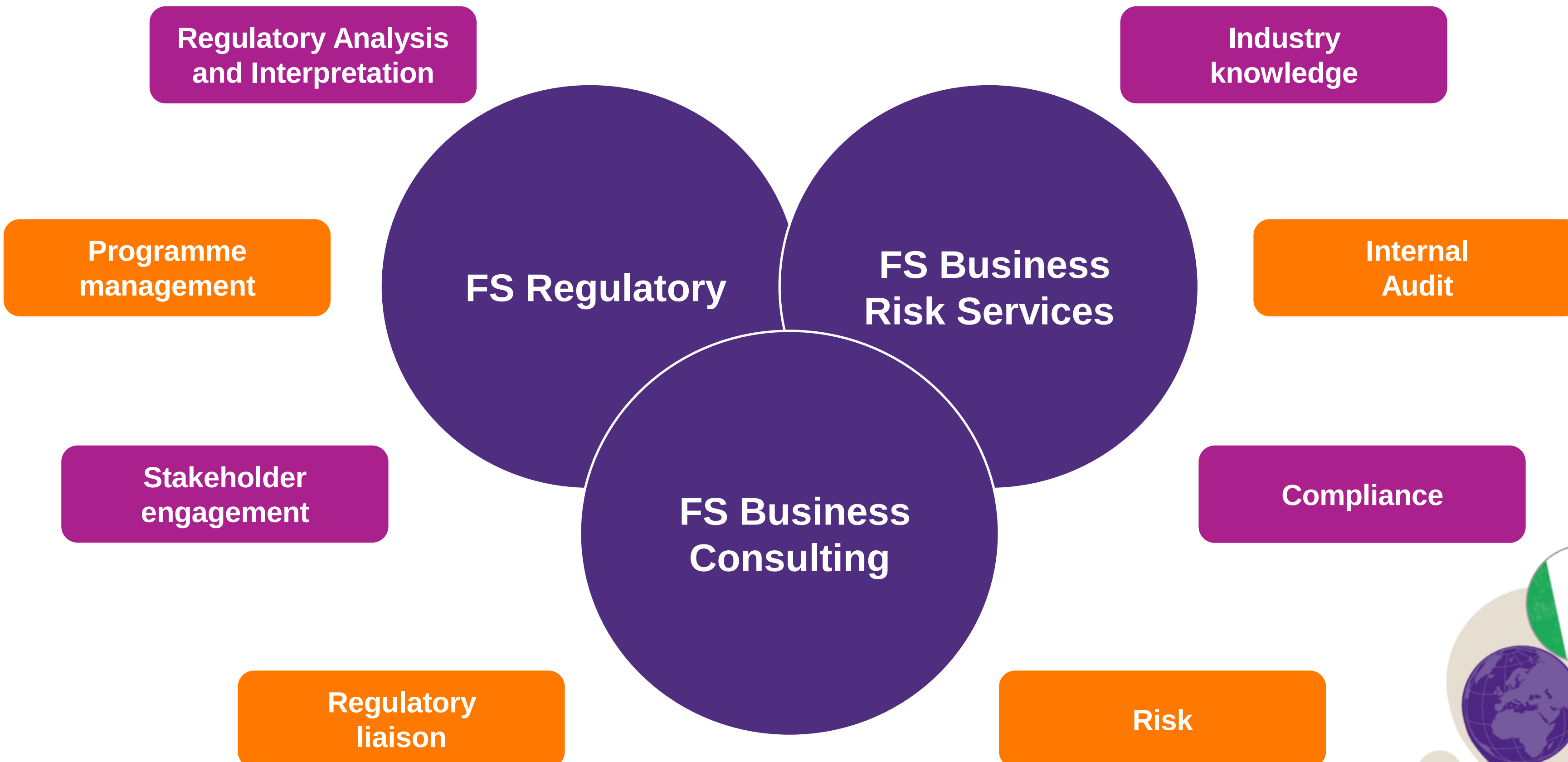
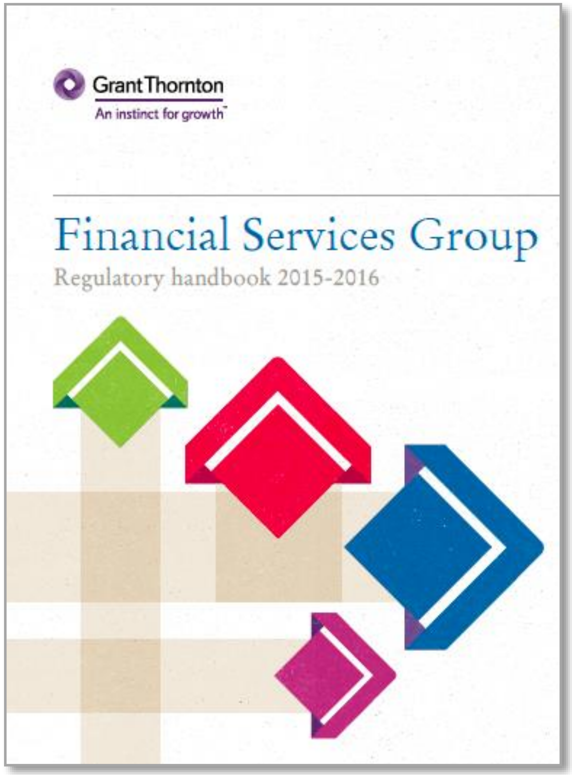
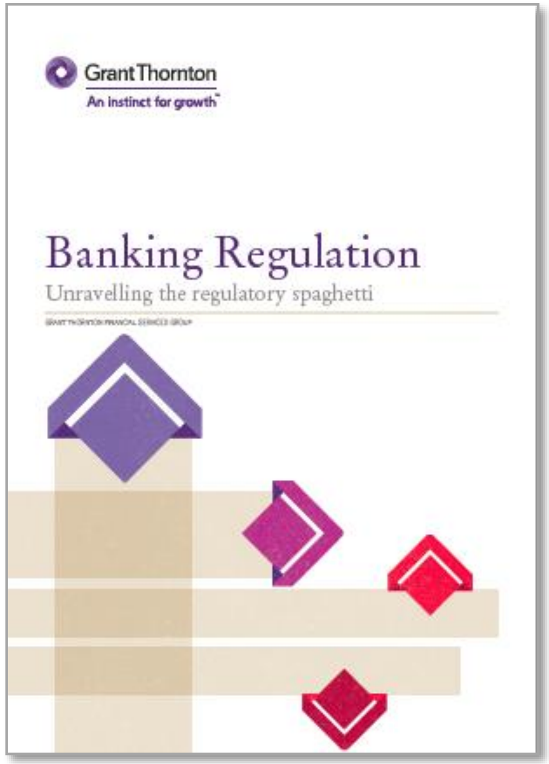
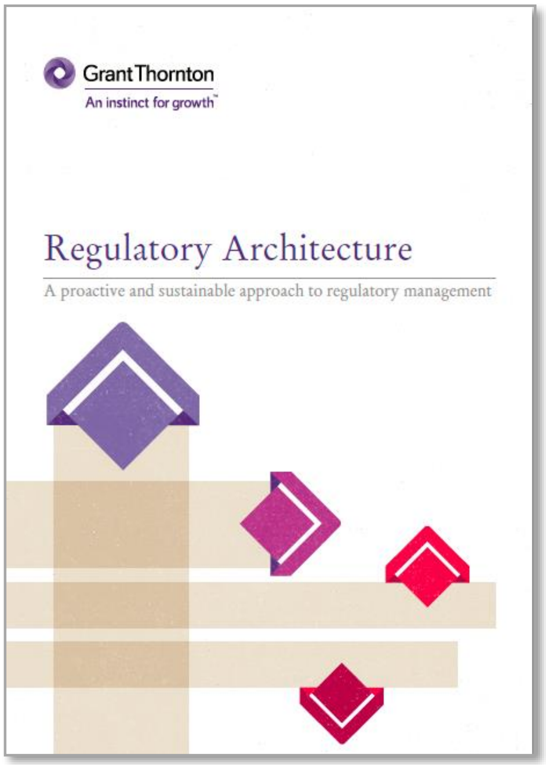
How Grant Thornton can help



Further reading







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MiFID II

Regulation spotlight

Scope and timelines

The revised MiFID and MiFiR (MiFID II) are due to take effect on **3 January 2017**. MiFID II will have significant impact on asset managers in the EEA

MiFID will apply directly to:

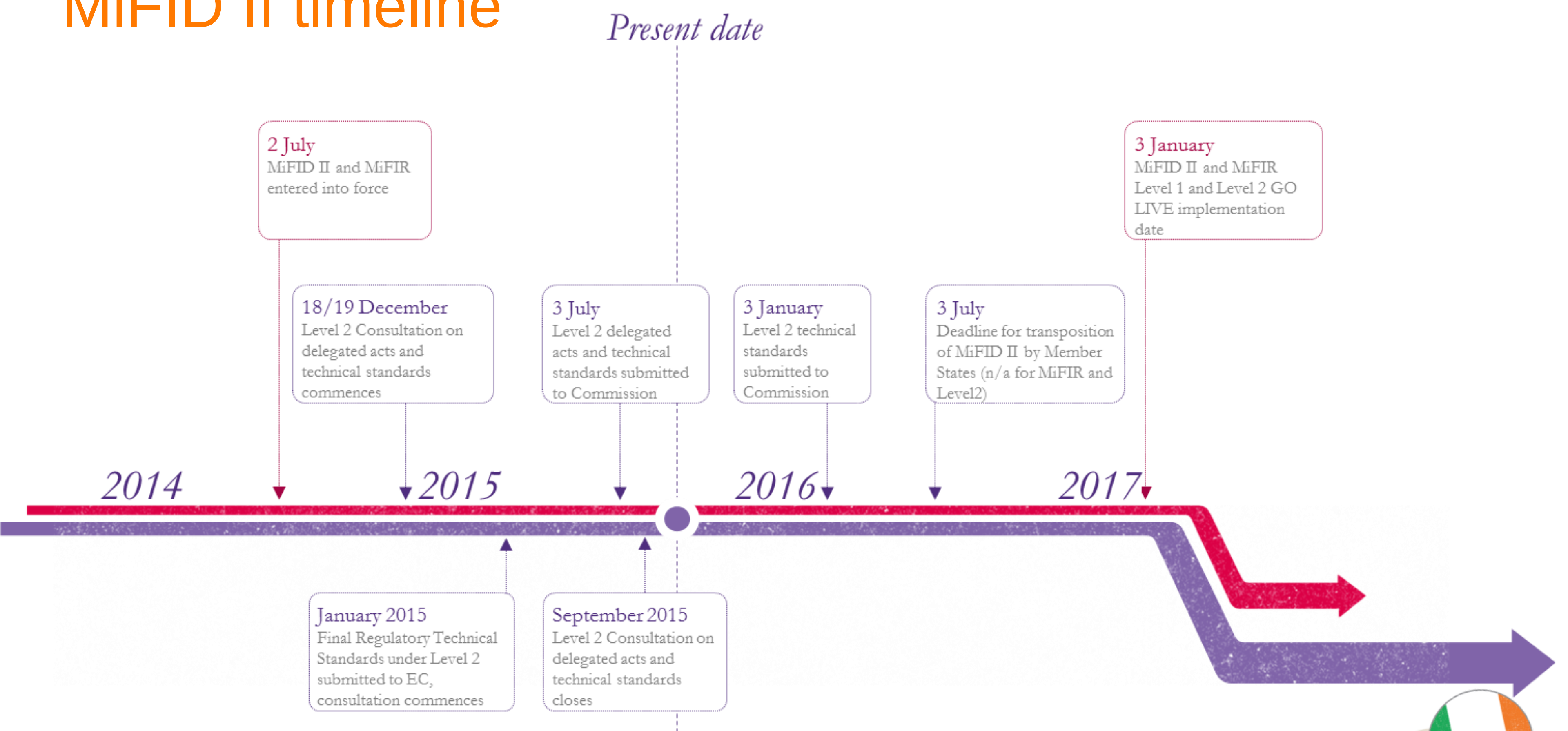
- MiFID investment firms (acting as portfolio managers and investment advisers)
- MiFID investment firms (acting as service providers, e.g. providing execution services)
- UCITS management companies authorised to provide MiFID investment services of individual portfolio management
- AIFM (authorised under MiFID to provide investment services such as individual portfolio management in respect of AIFs)

Scope and timelines

Level 2 measures

- ESMA has published several consultation papers on the Level 2 implementing measures
- ESMA is expected to submit Level 2 proposals to Commission in **January 2016**
- although the Commission is not bound to accept ESMA's final advice, the technical standards broadly reflect the direction of regulatory policy

MiFID II timeline



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Key changes and business impact

Objectives

- increased transparency and better investor protection measures to reinforce confidence
- provide better safeguards against the issues that the financial crisis has exposed as regards the functioning and transparency of financial markets
- undertake significant reform of investor protection regime

Key changes and business impact

Key changes:

- ban on inducements and Commission payments from third parties
- 'appropriateness' test extended to include more products (e.g. it will now cover structured UCITS)
- changes to the rules on best execution, suitability, trade reporting, transaction reporting, and portfolio and cost information for clients.
- greater transparency of market dealings.
- commodity derivative position limits

Key changes and business impact

Focus

- the focus of this presentation is on the **impact of changes to MiFID protection regime, on asset management service providers and funds industry**

Examples of enforcement actions and sanctions

UK
Founder & former investment manager
(2015)

13 years' imprisonment

"Fraud, using swap trades to artificially inflate Fund's performance, misleading investors"

US
Former
Lead portfolio
Manager
(2012)

Barred for 5 years

"Failure to exclude underlying CDO, experiencing an event of default from NAV calculation. Aiding and abetting the overstatement of the valuation of a mutual fund"

US
Global Asset
Manager
(2011)

$118 million

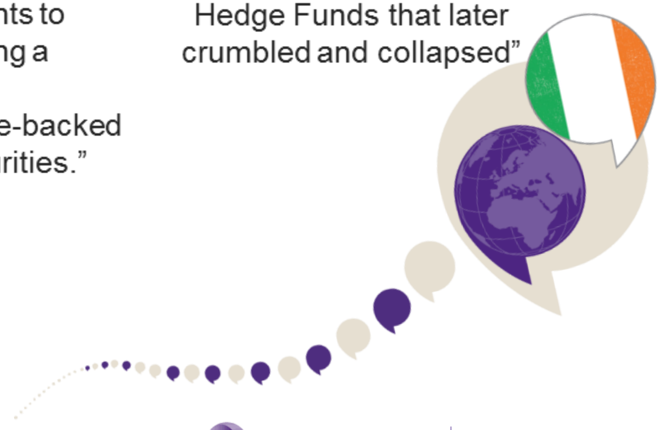
"SEC charged entities and executives with making misleading statements to investors in marketing a Mutual Fund heavily invested in mortgage-backed and other risky securities."

US

Global Bank
(2015)

$180 million

"defrauding investors in purportedly safe, low-risk Hedge Funds that later crumbled and collapsed"



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MiFID II: investor protection regime

Some Key Requirements

- Inducements and Commission payments
- Product design and distribution governance
- Suitability Assessments
- Best Execution
- Conflicts of interest
- Complex investments and appropriateness

Obligations of portfolio managers and independent advisers

Key requirements
• an investment firm must act honestly, fairly and professionally in accordance with the best interests of its clients • when advice is provided on an independent basis **a sufficient range of different product providers' products should be assessed prior to making a personal recommendation.** • independent financial advisors and individual portfolio managers **cannot be remunerated by third partie**s for services provided. • in order to avoid conflicts of interest, the **independent adviser or portfolio manager must be remunerated exclusively by the investor** to whom the services are rendered.
• applicable to MiFID portfolio managers and "independent advisers" • applicable to UCITS and AIFMD ManCos when providing MiFID individual portfolio services • not applicable to execution-only firms • not applicable to "Non-independent advisers"- but status unclear • although not applicable to UCITS/AIFMD fund managers, could impact indirectly on their distributions model

Ban on third-party inducements and commissions to portfolio managers and independent advisers

MiFID I	MiFID II
Essential requirements for the legitimacy of inducements to be paid by/to a third person (other than payments by or on behalf of the client) are: • **disclosure** of the nature and amount of the fee, commission or benefit, or • the third party payment must be designed to **enhance the quality of the relevant service** to the client; and • the third party payment **must not impair compliance with the firm's duty to act in the best interest of the client**.	• MiFID **portfolio managers** and "**independent advisers" cannot accept and retain fees, commissions or any monetary or non-monetary benefits paid by a third party** • **all fees and commissions paid by a third party must be returned in full to the client** • **only minor non-monetary benefits would be allowed** provided that they are clearly disclosed to the client, that they are capable of **enhancing the quality of the service provided** • remuneration of portfolio managers can therefore only be based on fees paid directly by the investor

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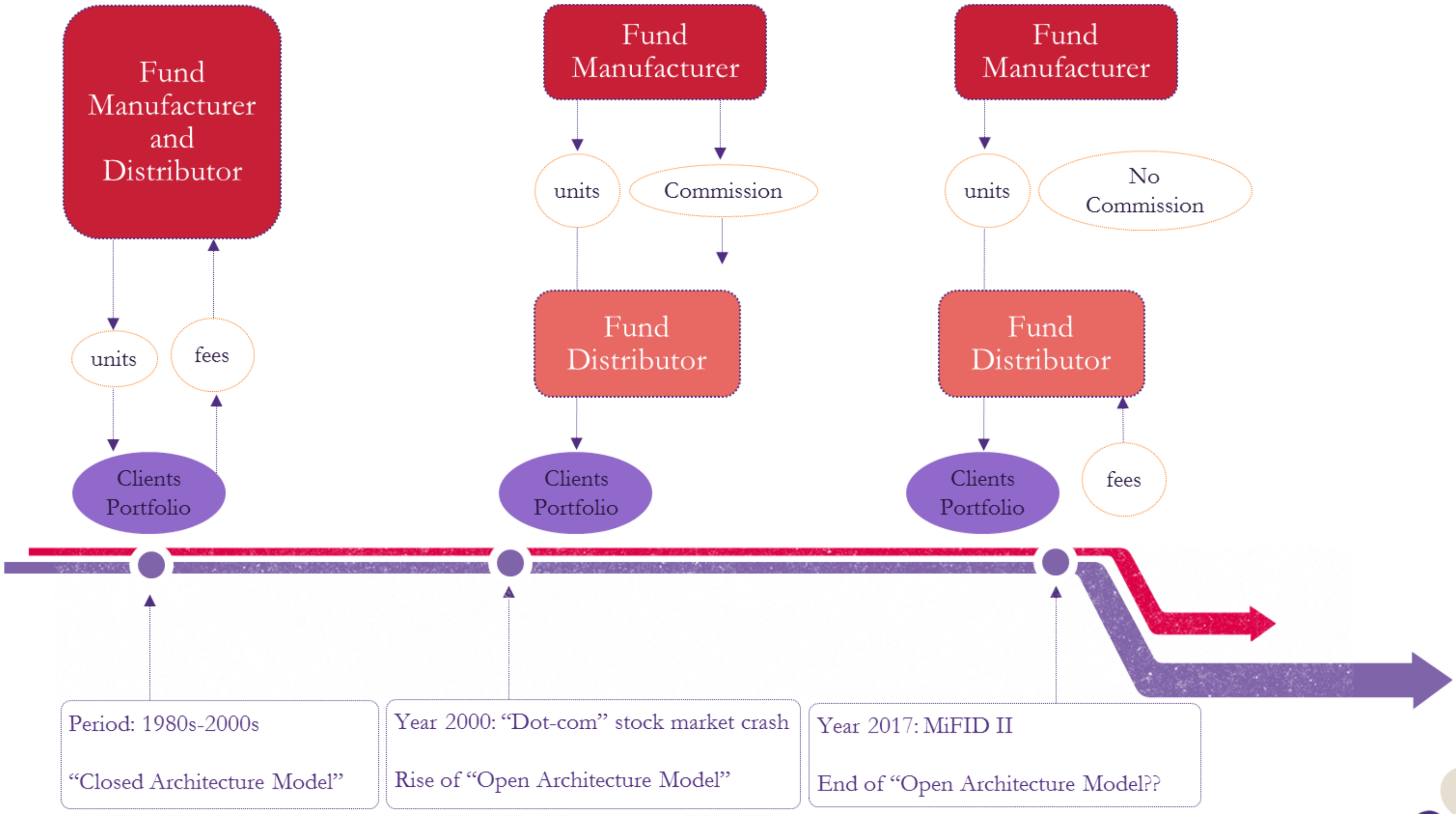
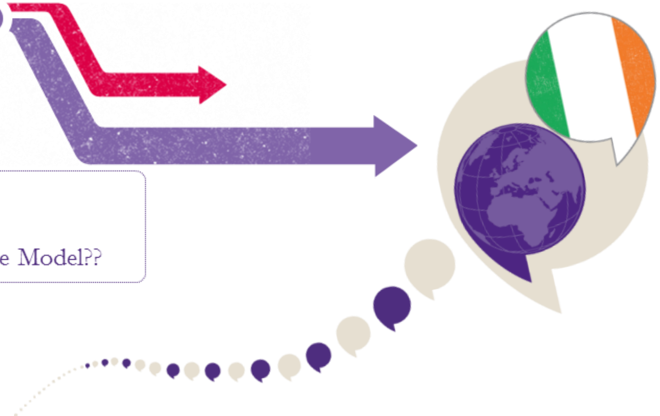
Fee-based structure: end of open architecture model?





Challenges of new fee-based funds distribution model

Would this arrangement be acceptable under MiFID II?

Excerpt from a fund prospectus approved by the Central Bank

"Distribution fees

… certain classes of Shares are subject to **an annual distribution fee**, in addition to the management fee. Such **distribution fee will be paid to the relevant sub-distributors** in consideration for providing specific distribution-related services, including but not limited to advising potential investors...."

MiFID II challenges
• fund managers, portfolio managers and distributors must conduct an impact analysis of the new requirements on their business model
• If the distribution fee is restricted under MiFID II: – distributors and manufacturers must implement new fee-based payment arrangement – prospectus, KID, marketing material, Transfer Agency payment arrangement system must be reviewed, Client money procedures must be amended
• from a strategic point of view, new business model must be considered • under the new model, the market will be more competitive for both fund managers and distributors • distributors have the obligations of assessing a sufficient range of fund managers before making recommendations • low cost passively managed funds such as Exchange Traded Funds (ETFs) will be a threat to traditional fund managers

EU survey: mis-selling and product governance

Issues identified by European Supervisory Authorities (“ESA”) in “Joint Position of the ESA on manufacturers’ product oversight and governance processes (2013)”

Denmark: “large scale mis-selling of highly complex structured products, and of units in funds based on hedging strategies.”

Belgium and Finland: “ increasingly complex products, such as structured products in Belgium or product wrapping in Finland”

Latvia: “structured products linked to the performance of underlying assets, such as market indices, equities, interest rates, fixed-income instruments, foreign exchange”

Estonia and Spain “(a) the poor presentation of risks associated with structured products; (b) an excessive degree of complexity (e.g. of index-linked deposits)”

Italy “distribution of complex products to retail investors… lacking liquid secondary market, and run a higher risk of being mis-valued, mis-charged and mis-sold”

France “has experienced some difficulties in the marketing of complex underlyings that were sold as units of account”

UK: “unregulated collective investment schemes investing in assets that are not always traded in established markets, are therefore difficult to value, may be highly illiquid”

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Presumption of appropriateness and suitability of regulated financial products?

Does the fact that a fund is regulated under UCITS or AIFMD absolve it from any claims of mis-selling?

Is there a presumption of appropriateness and suitability when a fund is regulated?

Extract from a KID of a UCITS absolute return fund

Objectives and investment policy

The fund aims to provide positive investment returns in all market conditions over the medium to long term.

It exploits market inefficiencies through active allocation to a diverse range of market positions. The fund uses a combination of traditional assets (such as equities and bonds) and investment strategies based on advanced derivative techniques, resulting in a highly diversified portfolio.

The fund can take long and short positions in markets, securities and groups of securities through derivative contracts.

Extract from a prospectors (KID) of an long tem growth fund

Objectives and investment policy

- the objective of the fund is to achieve long-term capital growth and income.
- the fund intends to gain exposure to debt instruments including but not limited to investment grade (high quality) and non-investment grade (lower quality) debt instruments.
- the fund intends to gain exposure worldwide in both developed and emerging markets.
- the fund may also gain exposure to the loans market through derivatives and other eligible complex instruments.
- the **fund will gain exposure through derivatives (complex instruments) and its total exposure can be up to twice the value of the fund**.
- the fund is actively managed within its objectives and is not constrained by a benchmark.
- any income from your investment will be reinvested.
- recommendation: this fund may not be appropriate if you plan to withdraw your money within five years.

Appropriateness assessment obligations

When providing investment services (other than investment advice and portfolio management), firms must ask clients to provide **information about their knowledge and experience** in order to be able to assess the appropriateness of the service or product offered or demanded.

There is an **exemption** from the appropriateness test for certain types of '**execution-only' business** if all of the following conditions below are met:

A. Non-complex instruments

i. s**hares** admitted to trading on a regulated market or on an equivalent third-country market or on a MTF, where those are shares in companies (**excluding shares in non-UCITS collective investment undertakings and shares that embed a derivative**)

ii. bonds or other forms of securitised debt admitted to trading on a regulated market or on an equivalent third country market or on a MTF, (**excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved**)

iii. money-market instruments, (**excluding those that embed a derivative or incorporate a structure which makes it difficult for the client to understand the risk involved)**

iv. shares or units in UCITS, **excluding "structured UCITS"**

v. structured deposits, (**excluding those that incorporate a structure which makes it difficult for the client to understand the risk of return or the cost of exiting the product before term**)

vi. other non-complex financial instruments.

B. the service is provided at the initiative of the client or potential client

C. the client or potential client has been clearly informed that in the provision of that service the investment firm is not required to assess the appropriateness of the financial instrument or service provided or offered and that therefore he does not benefit from the corresponding protection of the relevant conduct of business rules. Such a warning may be provided in a standardised format

D. the investment firm complies with conflicts of interest obligations

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Portfolio managers and investment advisers: Suitability test obligations

Article 25(2) MiFID II :

"Firm must obtain the necessary information regarding:

- the client's or potential client's **knowledge and experience** in the investment field relevant to the specific type of product or service,
- client's financial situation including **his ability to bear losses**,
- his investment objectives including **his risk tolerance** so as to enable the investment firm to recommend to the client or potential client the investment services and
- **financial instruments that are suitable** for him and, in particular, are in accordance with his **risk tolerance and ability** to bear losses.

New requirements: "Suitability reports"

When providing investment advice, Investment firm, must provide a report to the retail client that must include:

i. an outline of the **advice given**;

ii. **how the recommendation provided is suitable for the retail client**, including how it meets the client's objectives and personal circumstances with reference to the investment term required, client's knowledge and experience and client's attitude to risk and capacity for loss;

iii. an **explanation of the disadvantages of the recommended course of action**.

Product governance requirements

- obligation goes beyond the fundamental principle “Caveat Emptor”: "let the buyer beware”
- it is not enough for manufacturers/distributors to make disclosures (e.g. prospectus, KID)
- obligation to assess the the **compatibility of the product with the needs of the clients**

MiFID II Article 24:

Manufacturers

Investment firms which manufacture financial instruments for sale to clients shall **ensure that those financial instruments are designed to meet the needs of an identified target market of end clients** within the relevant category of clients, **the strategy for distribution of the financial instruments is compatible with the identified target market**, and the investment firm takes reasonable steps to ensure that the financial instrument is distributed to the identified target market

Distributors

An investment firm shall understand the financial instruments they offer or recommend, **assess the compatibility of the financial instruments with the needs of the clients** to whom it provides investment services, also taking account of the identified target market of end clients as referred to in Article 16(3), and ensure that financial instruments are offered or recommended only when this is in the interest of the client

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Product governance obligations for manufacturers

ESMA's proposed product governance arrangements	
Compatibility Test	Manufacturers must ensure that: • products are designed to meet the needs of an identified target market of end clients, • the strategy for distribution of the financial instruments is compatible with the identified target market • the financial instrument is distributed to the identified target market
Other obligations	• Ensuring that conflicts of interest are properly managed • Conducting regular reviews, to assess whether: – the product remains consistent with the needs of the identified target market – the intended distribution strategy remains appropriate. • undertaking a scenario analysis of product (e.g. market deterioration, counterparty default) • Ensure that product costs and other charges are compatible with the needs, objectives and characteristics of the target market
Challenges	• Manufacturers must implement robust product governance functions: – to identify needs of target market – to assess compatibility of product with target distribution market – for the oversight of the distributor's activities (validation of distributors' promotional materials)

Product governance obligations for distributors

<table>
<tr><th colspan="2">ESMA's proposed product governance arrangements</th></tr>
<tr><td>Compatibility Test</td><td>Distributor must implement product governance processes to ensure that the products and services that investment firms intend to offer are compatible with the characteristics, objectives and needs of an identified target market</td></tr>
<tr><td>Other obligations</td><td>• regular review of product governance arrangements to ensure that they remain robust and fit for purpose;
• provision of sales information to manufacturers, to meet post-sale product governance responsibilities
• compliance function/ board must be involved the development and periodic review of product governance arrangements</td></tr>
<tr><td>Non-EEA /Non-MiFID manufacturers</td><td>• when products are manufactured by non-EEA or non-MiFID firms, distributors should take all reasonable steps to ensure that:
– the level of product information obtained from the manufacturer is of a reliable and adequate
– products will be distributed in accordance with the characteristics, objectives and needs of the target market</td></tr>
<tr><td>Challenges</td><td>• distributors must implement robust product governance functions:
– to identify needs of target market
– to assess compatibility of product with target distribution market</td></tr>
</table>

Best execution: transparency and front office risk management

New Requirements

Best execution

Transparency
Publication of Top 5 venues

Monitoring obligation

Publication of information on the quality of execution

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Best execution

Core obligations

Obligation to obtain, when executing orders, the best possible result for clients

Publication of top five execution venues

Publication of the top five execution venues in terms of trading volumes where they executed client orders in the preceding year and information on the quality of execution obtained.

Monitoring requirements

Duty to monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies

Investment firms take all **sufficient steps to obtain, when executing orders, the best possible result for their clients taking into account price, costs, speed, likelihood of execution and settlement, size, nature or any other consideration** relevant to the execution of the order. Nevertheless, where there is a specific instruction from the client the investment firm shall execute the order following the specific instruction

Investment firms who execute client orders must summarise and make public on an annual basis, for each class of financial instruments, **the top five execution venues in terms of trading volumes where they executed client orders in the preceding year and information on the quality of execution obtained**

Investment firms who execute client orders **must monitor the effectiveness of their order execution arrangements and execution policy in order to identify and, where appropriate, correct any deficiencies.** In particular, they shall assess, on a regular basis, whether the execution venues included in the order execution policy provide for the best possible result for the client or whether they need to make changes to their execution arrangements, taking account of, inter alia, the information published under paragraphs three and six. Member States shall require investment firms to notify clients with whom they have an ongoing client relationship of any material changes to their order execution arrangements or execution policy

Deficiencies in best execution monitoring systems

In preparation for MiFID II, FCA issued recent useful findings on best execution (July 2014):

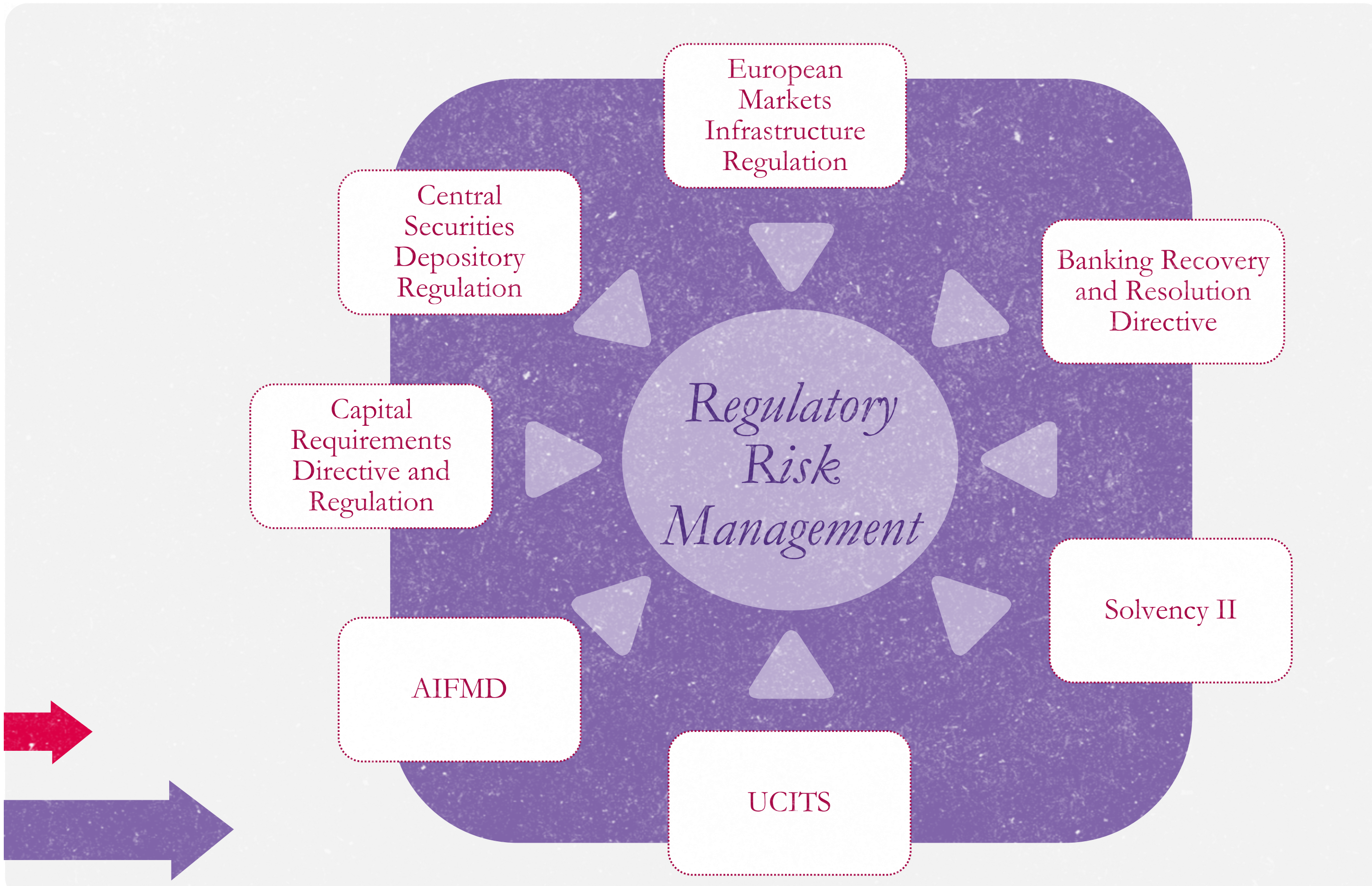
- most firms lacked effective monitoring capability to identify best execution failures or poor client outcomes.
- too much reliance on front-office monitoring. No robust capability to assess the data in the second line of defence
- no evidence of real-time monitoring/ end of the day monitoring
- no evidence of monitoring and analysis to support their selection of particular execution venues (e.g. market share, tenure and breadth of market coverage)
- using a very small or inadequate sample size for monitoring not sufficient to indicate that best execution was being provided on a consistent basis
- **benchmarks can be useful in monitoring best execution**
- this model allows firms to demonstrate that they are taking reasonable steps to get the best possible price for a client based on publically verifiable pricing data or assumptions

ESMA: proposed minimum standards for publication of information on quality of execution

In considering **minimum standards for publication of firms' own monitoring**, ESMA considers that investment firms would need to demonstrate that:

- monitoring included information on execution quality in respect of each class of financial instrument for which the firm executed client orders in the preceding year;
- their **published monitoring is based on a representative sample of client orders**;
- it distinguishes orders executed for different categories of MiFID client (given that different standards apply to retail and professional clients under the relevant rules and do not apply at all to eligible counterparties);
- they were **making use of the most recent publication of venue execution quality monitoring** that will be implemented under Article 27(3) of MiFID II;
- the **publication contains an adequate summary of all internal monitoring processes** (e.g. front office, second line and periodic review by compliance or audit functions);
- it includes adequate context or analysis to enable clients to understand how the firm assessed execution quality; and
- it **contained an indication of how the monitoring was, or would be, used by the firm (for example, whether corrective actions were being taken in response**).

MiFID II is a part of wider regulatory change



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Questions & feedback