EUROPEAN CAPITAL MARKETS INSTITUTE

ASSET MANAGEMENT CONFERENCE

REPORT

Mirzha J. de Manuel Aramendía
9/1/2010

Asset Management Conference - London - 16 September 2010
UK Financial Services Authority

Mirzha J. de Manuel Aramendía

Opening address
Lord Turner, Chairman, Financial Services Authority

1. On the regulation of hedge funds

The following extract from the Turner Review published by the FSA in March 2009, summarizes Lord Turner's intervention in the 2010 Asset Management Conference and the position followed by the UK Financial Services Authority with regard to the regulation of hedge funds.

The FSA already regulates UK domiciled hedge fund asset managers more extensively than several other regulatory authorities. These fund managers are FSA authorised and their business is subject to regulation and supervision consistent with FSA Rules and European Directives, covering the capital required to run an asset manager business and conduct of business. But the hedge funds themselves (which are usually legally domiciled offshore) are not currently subject to prudential regulations affecting their capital adequacy or liquidity. This reflects the fact that hedge funds in general are not today bank-like in their activities. Hedge fund leverage is typically well below that of banks – about two to three on average (Exhibit 2.5).36 They do not in general deal directly with retail customers (though they may have indirect contact via funds of funds). And they typically have not promised to their investors that funds are available on demand, and are able to apply redemption gates in the event of significant investor withdrawals. They are not therefore at present performing a maturity transformation function fully equivalent to that performed by banks, investment banks, SIVs and mutual funds, in the run-up to the crisis.

But hedge fund activity in aggregate can have an important procyclical systemic impact. The simultaneous attempt by many hedge funds to deleverage and meet investor redemptions may well have played an important role over the last six months in depressing securities prices in a selffulfilling cycle. And it is possible that hedge funds could evolve in future years, in their scale, their leverage, and their customer promises, in a way which made them more bank-like and more systemically important. In the 1970s and 80s, the major US investment banks (then typically described as broker dealers) were probably not systemically important to the US or global financial system, and a default might well have been absorbed without the catastrophic effects which the failure of Lehmans produced. Gradually over the succeeding decades however they did become systemically important, but authorities did not overtly recognise this fact and did not change regulatory and supervisory approaches to reflect it. We need a regulatory philosophy which in future will spot such an evolution and respond in time.

So the appropriate approach to hedge funds is that:

- Regulators and central banks in the performance of the macro-prudential analysis role need to gather much more extensive information on hedge fund activities (or on the activities of any other newly evolving form of investment intermediation) and need to consider the implications of this information for overall macro-prudential risks.

- And regulators need the power to apply appropriate prudential regulation (e.g. capital and liquidity

> rules) to hedge funds or any other category of investment intermediary, (or to otherwise restrict their impact on the regulated community) if at any time they judge that the activities have become bank-like in nature or systemic in importance.
>
> Source: The Turner Review, A regulatory response to the global banking crisis. March 2009. FSA.

Lord Turner and the FSA support the regulation of alternative investments for the reasons cited above. With regard to the Alternative Investment Managers Directive (AIFMD), the FSA wanted it to be focused on information gathering and reserved powers in case of build-up of systemic risk. This is one of the two objectives of the Commission's proposal, together with the protection of investors. The FSA does not agree with this second objective since these funds are targeted to professional investors. Lord Turner referred to the negotiations and the different compromise proposals, which make the outcome still unclear.

2. On remuneration policy

The FSA is consulting on the principle of proportionality and the remuneration rules from the Capital Requirements Directive so as to ascertain how to implement it in different parts of the industry. Asset Management will also be covered and in fact the AIFMD compromise proposal now incorporates an annex on this point. Yet, rules on remuneration need to take into account the scale of the risks posed by AIFM deemed lower than for banks and other institutions. It is nevertheless necessary to regulate remuneration in this sector to mitigate conflicts of interest and align staff incentives with investors and general interests.

3. On the FSA

a) The FSA will soon be divided into three parts:
   - One in charge of macro-prudential control, under the responsibility of the Bank of England.
   - One in charge of micro-prudential control.
   - One in charge of customer protection.

b) The FSA is reviewing its rules on retail distribution with the aim to counteract commission bias and conflict of interest, as well as to secure the availability of independent advice. The FSA is looking at how to apply this to WRAP platforms and fund supermarkets. It also wants to better understand the development of products at an earlier stage to ensure they are good for the consumer ("conduct-risk strategy").

Mirzha J. de Manuel Aramendía

Keynote session
Didier Reynders, Belgian Minister for Finance and Institutional Reforms

---

1. Regulatory mindset

Minister Reynders, who now leads the EU negotiations in financial affairs emphasized the following general ideas:

- Financial institutions need to do more risk management; active risk management, not only based on passed information. They need to make an effort to develop risk management science and techniques.
- The link between returns and risk needs to be emphasized.
- Financial institutions need to focus on long term returns, not short term ones.
- Top bank managers and members of the board need to understand the products their banks market. Financial institutions need to make an effort to develop attractive but transparent products.
- There is less ground now for self-regulation but it is still relevant.

- There is a need for more international regulation of financial markets and institutions.
- There are important international imbalances that need to be monitored and tackled.

- Markets in Europe need more integration. The new supervisory authorities at EU level are a good step in this direction.
- Jurisdictions which do not exchange information or conduct appropriate oversight of financial institutions, together with tax havens, need to be subject to restrictions and control.

- Value added of asset management industry has proved elusive in some regards during the past 20 years. Yet, the industry plays some very important economic functions in the provision of financing. There is a need to foster innovation in this sector, like in the whole of the financial markets, but it needs to be clever and balanced innovation.

2. Alternative Investments Funds Managers Directive

On the AIFMD, Minister Reynolds unveiled that the Belgian Presidency will push for an agreement that would feature a passport for third country funds. With regard to rules affecting private equity, the Minister emphasized the need to avoid discrimination amongst stake holders so that there is an equal playing field for all actors. In this sense, he believes it is possible to strike a good balance between the information private equity firms should submit to the market and the required discretion for some operations. According to Minister Reynolds, it is likely that an agreement on private equity rules will be achieved on the informal ECOFIN at the end of September. However, an agreement on third country rules is unlikely to be reached in the near future.

3. Other topics

On UCTIS IV and MiFID, the Minister emphasized the benefits that KII (Key Investor Information) brings together with unified certification standards that will boost transparency and competition.

On the taxing of the financial sector, the Minister recalled public pressure and made a clear statement supporting solidarity in this sense.

Panel session: The global regulatory outlook for asset management
Ugo Bassi, Head of Unit – Asset Management, European Commission

---

1. Regulatory mindset

Mr. Bassi explained that the European Commission, together with other national and international regulatory bodies, was starting to recover from the tense months that followed the crisis and was looking at the global picture again. He qualified the atmosphere inside the Commission of "hysterical" during those months and saluted the change in the mindset of regulators.

2. AIFMD and UCITS

With regard to the AIFMD, Mr. Bassi explained that the main objective of the Commission is to secure the approval of the Directive. He emphasized that the main objectives are shared by all parties.

On the UCITS IV Directive, Mr. Bassi unveiled that once the AIFMD is secured, the regime will be revised. He does not wish to call it UCITS IV since it will not be a general review. The purpose of this review will be to update the regulation in the light of the financial crisis and the regulatory reforms that have occurred since, the AIFMD in particular. Part of level 2 regulations in UCITS IV has been negotiated during the crisis and in parallel with the AIFMD, which unfortunately has given rise to some inconsistencies. Mr. Bassi pointed at the depository rules in UCITS, which will be reviewed in line with the AIFMD. He anticipated a stricter regime for depositaries under UCITS than under the AIFMD, since the former deal with retail investors. Further, he considered that a fundamental difference between both directives will need to be reconciled; he referred to the nature of the UCITS brand (voluntary) and the nature of the AIFMD (compulsory).

For the reform of the UCTIS regime, consultation with the industry will be conducted in the ordinary way, unlike for the AIFMD which, although subject to consultation at an early stage, was later rushed in the aftermath of the crisis.

3. Other initiatives

Mr. Bassi portrayed some other initiatives that the financial crisis had halted but which the Commission wishes to pursue in the near future:

- A package on retail investment products that will increase transparency and allow consumers to better understand and compare them. With regard to pre-contractual disclosure, a model similar to the KII (Key Investor Information) will be adopted horizontally, that is, for all retail investment products no matter which entity markets them (including banking and insurance). There will also be rules to regulate the conduct of business of the sellers.
- Sustainable investments (socially and environmentally).
- Access to finance by SMEs.
- Proposals for the asset management industry to contribute to a more competitive retirement pension market.

Panel session: The global regulatory outlook for asset management

Patrice Berge-Vincent, Head of Asset Management Department, AMF

Nicoletta Giusto, Head of the International Relations Office, CONSOB

Patrice Berge-Vincent, Head of Asset Management Department, AMF.

- Need for consistency across jurisdictions: Is there sufficient common supervision in the EU? How will the Dodd Frank Act affect the AM industry in Europe? What about the possible negative effects from the FATCA legislation for AM in Europe?

- What are Newcits? Are they a threat for UCITS? Where does this process of ever more complex products lead us to?

- Focus should be put on risk management. Little risk management requirements in the AIFMD are striking.

- Protection should be granted to retail investors not to professional investors like in the AIFMD

- Need for European vehicles for private equity that should be tax-neutral and mutually recognised (which is essential for the financing of SMES)

Nicoletta Giusto, Head of the International Relations Office, CONSOB

It is necessary to ensure consistency in the regulation of alternative investments internationally. Ms. Giusto does not see countries like the US or Switzerland adopting some of the rules under the AIFMD.

Ms. Giusto criticized the annex on the AIFMD about remuneration. While there is quite some consensus on the general principles, the annex is far too detailed and does not follow the Lanfalussy approach. As it stands today, the annex belongs more to the type of Level II provisions than to Level I.

Panel session: The UK as a place to do asset management business
Rich Kushel, Vice Chairman, Head of Portfolio Management, BlackRock
Guy Sears, Director, Wholesale, IMA
Elizabeth Corley, CEO, Allianz Global Investors Europe
Bill Scrimgeour, Global Head of Regulatory & Industry Affairs, HSBC Securities Services

Panellists agreed on the main reasons why the UK (and hence the EU, given the UK's dominance as financial hub of the Union) is losing part of its attractiveness:

- Lower costs offshore which have brought outsourcing of certain non-core activities; a phenomenon facilitated by IT.
- Tax pressure in the UK.
- More stringent immigration rules, which has an impact on the workforce of the financial sector.
- Uncertainty about the impact of new national and EU regulations.
- Lack of financial literacy compared to other emerging countries, both at a basic and advanced level.
- The tone of rhetoric about the industry that discourages young people to become professionals in finance.

Some of the panellists forecasted the emergence of hubs in Asia in the coming years, in a Luxembourg-like fashion. They emphasized the interest of countries like Korea, Australia, Singapore or China in promoting their jurisdictions to managers.

Small managers are thought to be more likely to move abroad, although they also are likely to merge under UCITS IV.

Elizabeth Corley, CEO, Allianz Global Investors Europe

Ms. Coley made a fierce defence of better regulation and heavily criticized the lack of holistic approach and strategic thinking. In her view, much of the regulation coming from the EU and the UK recently has been made in a reactive mood with little consultation. She emphasized the need to regain traditionally high levels of consultation and for the industry to make transparent technical contributions in these processes. Ms. Corley advised regulators to undertake reform, doubtless necessary, step by step, fixing objectives first and giving careful consideration to means via good cost-benefit analysis. It was highlighted that one of the victims of the crisis has been the trust between regulators and industry; it was felt this was at least in part the fault of the industry itself.

As to rules on remuneration in the Capital Requirements Directive and AIFMD, Ms. Corley pointed at some of the negative effects from limiting the weight of variable compensation in the remuneration mix. She underlined that the industry wishes to employ people over the long term, in line with its fiduciary duties and that this requires variable remuneration. If fixed remuneration becomes too high, Mss. Corley fears that the negative impact in the elasticity of labour will mean that a substantial part of employees will be hired and fired with the cycle. The ability to reduce compensation, when market conditions so require, seems essential.

Panel session: The impact of regulatory changes in custody
David Morrison, Chairman, DATA
Stephen Smit, Executive Vice President, State Street
John Siena, Assistant General Counsel, Brown Brothers Harriman
Nadine Chakar, Head of Global Financial Institutions, BNY Mellon

---

Stephen Smit, Executive Vice President, State Street

Citing a study from McKinsey, Mr. Smit highlighted that while assets under management have recovered to pre-crisis levels benefits for managers were around 75%, probably because of the use of less lucrative strategies (like cash strategies). He pointed out at the increasing demand by managers for outsourced services to reduce costs and forecasted an increase in the path of this phenomenon. This booming demand for asset servicing involves activities such as custody, accounting, fund administration, collateral management, OTC derivatives processing, and even the outsourcing of investment management.

With regard to UVITS IV, Mr. Smit considered that there the industry has not yet acted on the basis of this directive, which was however met with huge expectation. He considered that the two most important changes were the master feeder structures and the management passport.

As to the AIFMD, Mr. Smit considered the regime for depositors and told the audience he finds two main causes of concern:

- The provisions imposing quasi-strict liability on custodians creates a bigger burden in terms of risks faced by these operators, which is likely to raise costs that will ultimately be passed on to investors. He considered that there is a real risk that fund managers will experience difficulties in finding custodians willing to undertake this level of risk. He also explained that the strict liability regime will probably increase concentration on the custodians' side of the industry. It is feared that higher concentration will increase systemic risk. With regard to the French proposal to allow for the contractual discharge of liability, he showed certain scepticism.

- According to Mr. Smit, the provisions that regulate the delegation of depositary functions are overly strict, as well as unclear. Mr. Smit referred to the restrictions on the functions that may be delegated and the requirements for sub-custodians that he fears may cause some markets to become inaccessible for foreign investment. He considered that the requirement for an objective reason to justify delegation, contained in the draft proposal, will give rise to extensive debate during the Level II implementation.

Nadine Chakar, Head of Global Financial Institutions, BNY Mellon

Ms. Chakar commented on the impact of the Dodd–Frank Act on the European asset management industry that remains uncertain. She emphasized that service providers that operate globally need compatible regulations in different jurisdictions and urged for consistent reforms across the Atlantic.

John Siena, Assistant General Counsel, Brown Brothers Harriman

Mr. Siena centred his intervention with regard to the changes in the regulation for custodians in four points.

First, on the need for legal certainty and consistency. Mr. Siena emphasized the divergences between the UCITS and proposed AIFMD regime, in particular with regard to depository obligations. He also considered that these divergences affect custody elsewhere in the financial industry. Finally, he warned about the disconnection between on-balance and off-balance assets and their custody.

Second, he referred to the paradigm shift from the Anglo-Saxon fiduciary duties for custodians to the Continental approach to restitution (in reference to the change from duty of care to quasi-strict liability for custodians).

Third, he explained the reallocation of roles and responsibilities that will likely occur in the industry given the changes in allocation rules. Mr. Siena considered that custodians will need to be involved much more in the formulation and investment strategies. Panellists made reference to having "a custodian sitting next to you in the investment desk".

Fourth, he referred to systemic risk and the strict liability standard. Mr. Siena argued that the next financial crisis may be prompted by this liability regime. He wondered how fund managers and banks will behave in a world of strict liability for custodians.

David Morrison, Chairman, DATA

Mr. Morrison converged with other panellists on the idea that custodians do not only provide asset services but also assume risk. Strict liability will increase this risk and hence the costs, which may drive some operators out of the market, reduce competition and make the EU a less attractive place for global investors. He pointed out at the increase in macro-risk that will arise due to further concentration of the depositories.

Reference was also made to the surveillance that custodians will need to undertake over fund strategies and day-to-day operation.

The industry seems committed to argue its position at the Level II stage of implementation of the AIFMD and in the revision of UCITS.

Panel session: The development of the European and global funds industry post AIFMD
Dan Waters, Asset Management Sector Leader, FSA
Jamie Broderick, Managing Director, Head of Europe and Latin America, JP Morgan
Ludo Bammens, Director of European Corporate Affairs, KKR
Todd Groome, Chairman, AIMA
Peter Clarke, CEO, Man Group plc

Ludo Bammens, Director of European Corporate Affairs, KKR

Mr. Bammens observed that there is no definition of private equity in the AIFMD, as there are no definitions for other types of funds. However, he considered that negotiations have brought progress in terms of tailoring of requirements in the directive to different kinds of funds.

Most of his intervention was centred on how private equity and other funds will be marketed in Europe after the AIFMD enters into force. There is uncertainty about the final result of negotiations but, given that EU investors are a minority for most managers, Mr. Bammend cast doubts about funds relocating to the EU. He added that splitting funds would increase costs and would probably not solve the problem since the directive will be applicable to all managers from the moment they market a fund to EU investors. Mr. Bammens also pointed at the uncertainty surrounding the application of these rules to portfolio companies, holdings and subsidiaries. In addition, he referred to the different treatment of active and passive marketing under the proposed AIFMD.

Mr. Bammens warmed against discriminating non-EU funds by not granting them a passport and considered the likely harm for EU firms when seeking access to long term finance, which is not so readily available.

Peter Clarke, CEO, Man Group plc

Mr. Clarke emphasized the importance of satisfying investors' needs and preferences. He asserted some hard facts:

- An EU manager does not perform better than a non-EU based manager so investors will likely not understand some of the costs imposed by the AIFMD.
- Some investors do not require nor desire protection; some investors do not want a UCITS like regime for alternative investments.
- There are however other investors who want to invest in regulated funds and are a big incentive for fund to move on-shore. He considered that this phenomenon is already happening so the AIFMD will not force this upon managers in practice.
- If costs rise, there will be consolidation in the hedge fund industry.

Jamie Broderick, Managing Director, Head of Europe and Latin America, JP Morgan

Mr. Broderick considered the impact of regulation on funds and other financial actors depending on his size. He explained that for a company like JP Morgan, adjusting its operation in order to comply with regulatory requirements represents a source of cost but it is a cost that can be assumed given the size of their business. He set the contrast with the situation of small companies for which a slight increase in costs may force closures. As a final remark on this, he reflected on consumer confidence and asserted that if these reforms help regain lost trust and bring clients to invest more, they might turn out to be good for the industry as a whole.

Mr. Broderick considered that some of the regulation coming from the EU was "tightening screws" rather than making clear policy commitments. He gave as example of good regulation, the Volker rule in the US, driven by a far reaching objective of public policy. He considered on the other hand that the AIFMD was too much focused on the manager and the product while not so much in the relationship between clients and sellers. He emphasized that Key Investor Information documents are useful but do not address processes of selling; in his opinion there is a need for more control of these. He explained that managers do not control the value chain of a fund (UCITS in particular) because they are distributed by third parties in most cases.

Mirzha J. de Manuel Aramendía

Panel session: The capital markets and regulatory change
Sharon Bowles MEP, Chair of the Economic and Monetary Affairs Committee
Mark Northwood, Global Head of Trading, Fidelity
Natasha de Terran, Director US Public Affairs, LCH Clearnet

Sharon Bowles MEP, Chair of the Economic and Monetary Affairs Committee

Ms. Bowles gave an overview on the atmosphere at the European Parliament after the entering into force of the Treaty of Lisbon. She described the mood of parliamentarians as more prone to be demanding and courageous at negotiations. She felt however that not all MEPs were receptive to technical discussions of a complex nature and received input from the industry with a lot of mistrust.

Ms. Bowles also commented on the accumulation of legislation in the area of finance. She told the audience it was natural to have a certain feel of indigestion. She advanced the intention of EU co-legislators to extend some of the provisions in MiFID to other asset classes.

Mark Northwood, Global Head of Trading, Fidelity

Mr. Northwood considered the advantages and disadvantages that MiFID and the liberalization of trading platforms had brought to Europe.

Natasha de Terran, Director US Public Affairs, LCH Clearnet

Ms. de Terran portrayed the clearing industry as net beneficiary of recent regulatory reforms. Nevertheless, she also elaborated on the need for clearing and settlement firms to understand better the needs of their clients and work together to find the best possible solutions for the new realities in markets worldwide.

Mirzha J. is assistant researcher at ECMI. He can be contacted at mirzha.demanuel@ceps.eu.

About ECMI – The European Capital Markets Institute

ECMI is an independent non-profit organization created to provide a forum in which market participants, policy-makers and academics alike can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the latest market trends.

These exchanges are fuelled by the publications ECMI regularly produces for its members: quarterly newsletters, annual reports, a statistical package, regular commentary and research papers, as well as occasional workshops and conferences. ECMI also advises European regulators on policy related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject.

ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Its membership is composed of private firms, regulatory authorities and university institutes.

www.eurocapitalmarkets.org | info@eurocapitalmarkets.org

Place du Congrès 1 | 1000 Brussels | Tel: 32(0) 229.39.11 | Fax: 32(0) 219.41.51

About CEPS – The Centre for European Policy Studies

Founded in Brussels in 1983, the Centre for European Policy Studies (CEPS) is among the most experienced and authoritative think tanks operating in the European Union today. CEPS serves as a leading forum for debate on EU affairs, but its most distinguishing feature lies in its strong in-house research capacity, complemented by an extensive network of partner institutes throughout the world.

CEPS' funding is obtained from a variety of sources, including membership fees, project research, foundation grants, conferences fees, publication sales and an annual grant from the European Commission.

www.ceps.eu