Global Funds Developments and Regulatory Update

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European Regulatory Developments for Retail Fund Managers

UCITS – WHERE ARE WE NOW?

- UCITS V implementation
  - Depositary agreements
  - Fund documentation
  - Remuneration confusion

- Brexit
  - Immediate issues
  - Medium-term threats and opportunities

- Liquidity issues / UCITS VI?

PRIIPS

- **Application to UCITS managers**
  - Transitional period
  - Sting in the tail?

- **Particular issues**
  - Risk indicator
  - Performance scenarios
  - Charges
    - Costs over time
    - Composition of Costs
  - Consequences for Factsheets**?**

Developments in International Fund Regulations (Germany)

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LOAN ORIGINATING FUNDS (LOF) IN THE EU

The Past

- EU
  - no common framework for LOF
  - majority of member states allowed LOF (partly or fully), e.g. Ireland, Spain, Italy, Malta
  - Action Plan on Building a Capital Markets Union as of 30 September 2015, particularly EuVECA, EUSIF, ELTIF
- Germany: LOF prohibited until circular by BaFin as of 12 May 2015, however, LPF allowed

The Present

- EU: Opinion by ESMA on key principles for a European framework on loan origination by funds (11 April 2016)
- Germany: statutory rules for LOF introduced as part of transposition of UCITS V as of 18 March 2016

The Future

- European Commission: consultation re LOF planned for Q2/2016
- Common Framework for LOF in the EU

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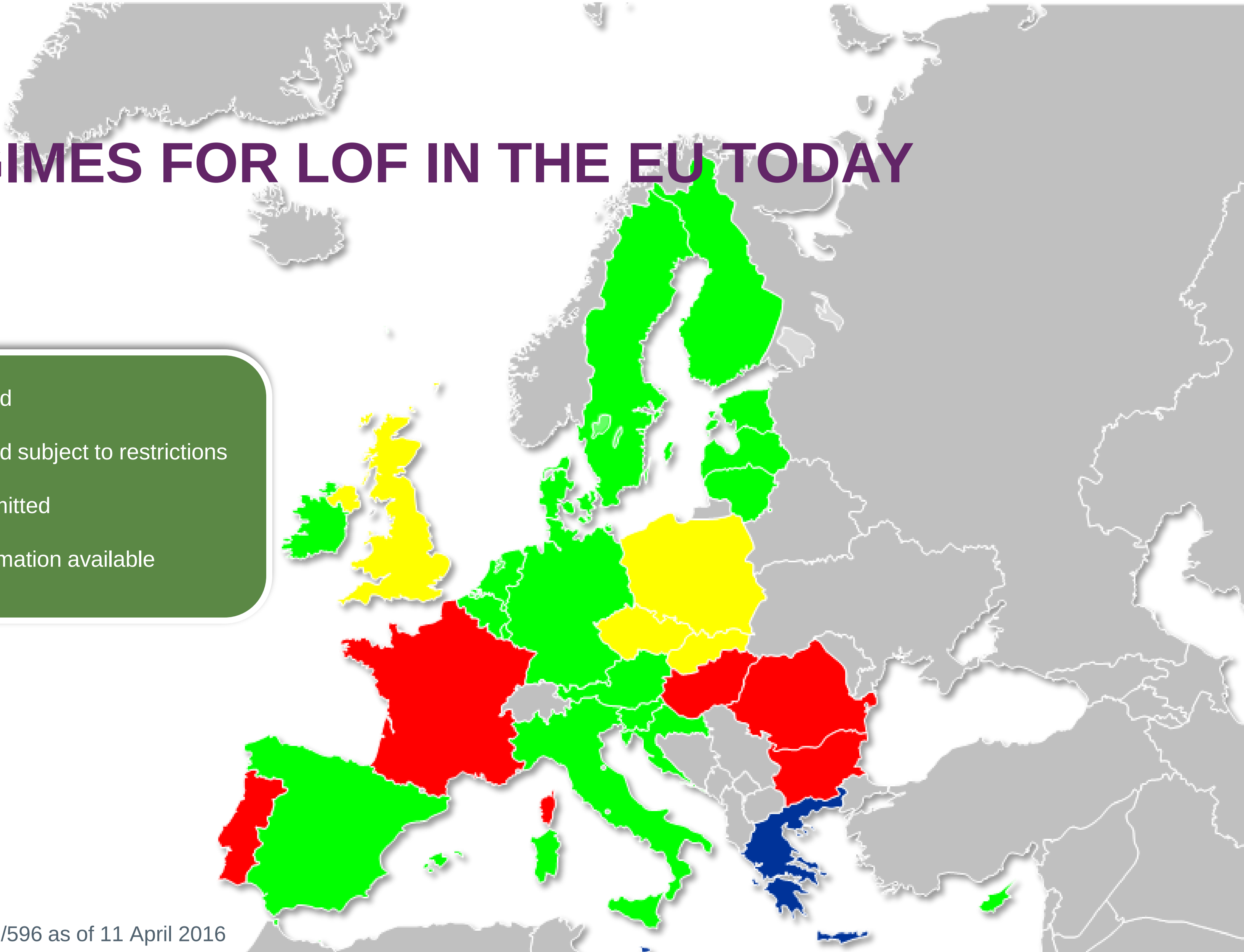
REGIMES FOR LOF IN THE EU TODAY



Source: ESMA/2016/596 as of 11 April 2016

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ISSUES FOR COMMON FRAMEWORK

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LOF IN GERMANY (I)

Germany

AIF
- Product Rules applicable in Germany

AIFM
- Authorized in Germany
- Loans as portfolio management
- only services and ancillary services in accordance with KAGB

EU

AIF
- Product Rules in accordance with jurisdiction of domicilation

AIFM
- Authorized in EU member state
- Loans as portfolio management
- only services and ancillary services in accordance with AIFMD

Third Country

AIF
- Product Rules in accordance with jurisdiction of domicilation
- Marketing permissible in Germany
- Non-EU-AIF or EU-AIF is not only marketed in Germany to professional investors in accordance with § 330 KAGB (Art. 42 AIFMD)

AIFM
- Seat in non-EU member state
- Meets requirements as AIFM under AIFMD

LOF IN GERMANY (II) – PRODUCT RULES (I)

<table>
<tr><td>UCITS</td><td colspan="5">AIF</td></tr>
<tr><td>Not permitted</td><td colspan="3">Special</td><td colspan="2">Retail</td></tr>
<tr><td></td><td colspan="2">Closed-ended</td><td>Open-ended</td><td>Closed-ended</td><td>Open-ended</td></tr>
<tr><td></td><td>Loans</td><td>Shareholder Loans</td><td>Shareholder Loans</td><td>Shareholder Loans</td><td>Not permitted</td></tr>
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LOF IN GERMANY (III) – PRODUCT RULES (II)

Loans

Leverage of no more than to 30% of committed capital

No loans to consumers

No more than 20% of committed capital granted to single borrower

Shareholder Loans

Participation in borrower required

No more than 50% of committed capital

- except for subordinated loans, if leverage is not more than 30% of committed capital
- in case of closed-ended retail AIF, only 30% of committed capital

One of the following conditions is fulfilled:

- company is controlled by AIF
- loan is subordinated
- loan amount does not exceed 200% (or, in case of closed-ended retail AIF, 100%) of the acquisition costs for the participation

Loans to companies controlled by AIF may only granted if it is ensured that funds are on-lent only on the same conditions

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LOF IN GERMANY (IV) – ORGANISATIONAL REQUIREMENTS FOR AIFM

Controls and Procedures

- Special controls and procedures for loans, in particular work-out, control of work-out, problem loans, early risk detection
- Minimum Requirements for Risk Management (MaRisk)
- Principle of Proportionality

Reporting

- Loans to a borrower exceeding € 1 million
- Quarterly to Deutsche Bundesbank
- Notifications by Deutsche Bundesbank if borrower has more than one loan exceeding € 1 million, including information on total indebtedness and probability of default

Sub-Threshold AIFM

- Controls and Procedures
- Reporting of loans exceeding € 1 million
- Rules of Conduct: acting in the sole interest of the investors in particular: due diligence, conflicts of interest, resources
- Risk management separated from market function
- Liquidity managment except for closed-ended AIF without leverage

European Long-Term Investment Fund (ELTIFs)

ELTIF KEY FEATURES

- **AIFMD regime:**
  - ➢ Alternative investment fund (AIF)
  - ➢ Managed by a European alternative investment fund manager (AIFM)
  - ➢ Investing in long-term assets
  - ➢ Raises capital from institutional and retail investors across EU
- **AIFMD passport** – for retail <u>and</u> professional
- **Minimum investment** – €10,000; investor portfolio
- **Closed-end** – but <u>some</u> redemption flexibility
- **Disclosure / transparency** – AIFMD, Prospectus Directive, PRIIPs

ELTIF INVESTMENT PORTFOLIO

Investment powers / restrictions

Eligible assets:
- 70% in infrastructure projects, equity, debt, loans

Leverage
- Up to 30% of the capital of the fund

Diversity:
- Max 10% in assets of single issuer or single asset

Opportunities

- Private equity (equity / equity related instruments of SMEs)
- Loan based / debt investments for SMEs
- Other ELTIFs, EUVECA, EuSEFs
- Real estate
- Real assets (ships, planes, facilities, machines)
- Infrastructure projects

U.S. Fund Regulatory Initiatives

US FUND REGULATORY INITIATIVES

- **Brief Overview of Proposed Liquidity Risk Management Rules: Proposed Rule 22e-4**
  - **Implementation: Building, documenting, and adopting a framework for the Funds' program to manage liquidity**
- **Swing Pricing: Proposed Rule 22c-1(a)(3)**
  - **How swing pricing works**
  - **Swing threshold considerations**
  - **Swing Factor considerations**
  - **European funds (UCITS) experience with swing pricing**
- **Proposed rules regarding US funds' investments in derivatives**

PROPOSED LIQUIDITY MANAGEMENT RULES

- Proposed Rule 22e-4 requires a written liquidity risk program:
  - Classification of every security in the portfolio
  - Assessment and periodic review of the liquidity risk of the fund
  - Board approve a Minimum 3 day liquid assets determination
  - 15% maximum for standard assets (not sold at approximate value in 7 days)
- Reporting requirements to the SEC and public disclosures:
  - Form N-1A
    - Disclosure requirements regarding redemption policies
    - Swing pricing if applicable
  - Form N-PORT
    - Detailed liquidity classifications
    - 3 Day Liquid Assets and 15% Standard Assets
  - Form N-CEN
    - Reporting on lines of credit, Inter Fund Lending and Swing Pricing
    - ETF reporting requirements (AP collateral posting)

LIQUIDITY RISK FRAMEWORK: AN INTEGRATED ANALYSIS OF LIQUIDITY CONSIDERING ASSETS, LIABILITIES AND TOOLS

Asset Analysis:

- Level of Minimum Liquidity a function of Asset Class, Concentration, Strategy

Liability Analysis:

- Concentration of Holders
- Volatility of Cash Flows –During normal times and periods of stress
- Control over Redemption Process

Fund/Advisor Specific Issues:

- Portfolio manager/Team Turnover
- Performance: metrics for poor performance, negative changes in performance
- Asset growth: Dramatic asset growth, sources of growth, stability of assets
- Changes in distribution: change in channel, changes within the channel

Tools for Managing Liquidity:

- Cash and Assets Qualifying for 3 Day Liquidity designation
- Alternative Sources of Liquidity: Inter Fund Lending and Lines of Credit
- Delayed Settlement: Alternative to providing next day settlement

IMPLEMENTATION OF FRAMEWORK

Framework initially designed at a high level:

- Key decisions on approach are necessary before the framework should be designed
- Variables used for asset classification, which system will house the variables
- Process flexible enough to incorporate swing pricing needs if necessary
- Any adjustments to tools: Credit facility, Inter Fund Lending, Settlement

Determine potential data needs, identify any gaps and begin process of collecting data:

- May not currently be collecting the necessary data-review the rule and design the
- process to start collecting the needed data
- Retain and process the necessary data for liability analysis-holder data and cash flows

Asset Classification System:

- Efficient design of assigning a security to a liquidity bucket
- Logic must be straightforward and objective

Swing Pricing:

- Does it make sense to implement at all? Across complex or fund by fund basis.
- Are resources available to implement both liquidity risk rules and swing pricing?
- Changes in operational processes. Feasibility with cut-off times for cash flows.

SWING PRICING

Swing Pricing Background

- Dilution of existing shareholders may occur because redeeming shareholders transact at the fund's next calculated NAV, which does not reflect trading costs
- Intended to protect existing shareholders against dilution by attributing the estimated financial impact (trading and market impact costs) to the redeeming/purchasing shareholder(s)
- Voluntary - permits open-end non-MMF, non-ETF funds to use swing pricing
- SEC proposal was for "partial" swing pricing only

Swing Threshold and Swing Factor

- Threshold – Level at which a swing factor is triggered, i.e., when net purchases or redemptions exceed a specified percentage of NAV
- Factor – Amount by which NAV is adjusted up or down
  - Purchases > threshold – NAV adjusted upward by factor amount
  - Redemptions > threshold – NAV adjusted downward by factor amount

SWING PRICING

Setting the Swing Threshold - Considerations:

- size, frequency and volatility of historical net purchases or net redemptions during normal and stressed periods
- investment strategy and liquidity of the fund's portfolio assets
- cash, cash equivalents, borrowing arrangements and other funding sources
- costs associated with transactions in the markets in which the fund invests

Swing Factor Considerations:

- any "near-term" costs expected to be incurred by the fund in order to meet a purchase or redemption request (e.g., market-related costs, spread costs, transaction fees, borrowing-related costs)
- the value of assets purchased or sold by the fund to satisfy purchase or redemption requests, if such information would not be reflected in the fund's current NAV computed that day
- Adjustments apply equally to all purchasing or redeeming shareholders

SWING PRICING – BOARD OF DIRECTORS

- As part of a Board’s general obligations with respect to valuation, Board must initially approve swing pricing policies and procedures and any subsequent material changes

- Board must designate the fund’s investment adviser or officers responsible for administering the swing pricing policies and procedures

- Board would not be responsible for managing day-to-day administration

- Board may establish a swing pricing committee (per SEC suggestion)

DERIVATIVES RULE PROPOSAL

- The SEC designed the rule to provide a "modernized, more comprehensible approach" to derivatives regulation
- The proposed rule would limit the way mutual funds, closed-end funds, and ETFs use derivatives and create risk management measures designed to protect investors
  - Portfolio limitations
  - Asset segregation
  - Risk management program
- The rule would replace the existing asset segregation regime developed over the last 35+ years

DERIVATIVES RULE PROPOSAL

- A fund must comply with one of two portfolio limitations, designed to limit leverage the fund may obtain through derivatives and financial commitment transactions
  - *Exposure-based portfolio limit*
    - Aggregate exposure cannot exceed 150% of net assets
    - Exposure is the sum of the aggregate notional amount of derivative transactions, financial commitment transactions, and other senior security transactions
  - *Risk-based portfolio limit*
    - Aggregate exposure is limited to 300% of net assets if the fund can satisfy a risk-based test
    - The VaR-based test is intended to determine if the aggregate effect of derivatives transactions decreases the market risk of the fund's portfolio
- The exposure limits are in addition to exposure from the fund's securities portfolio

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CURRENT VS. PROPOSED SCHEME

	Current Scheme	Proposed Scheme
Leverage Limitations	Permitted senior debt securities must meet 300% asset coverage ratio; no cap on leverage obtained through derivative positions if segregation obligations are met	Asset coverage requirements for senior debt securities remain – and – Absolute ceiling on leverage senior security-like transactions equal to 150% NAV, or 300% NAV if the fund satisfies the risk-based test
Asset Segregation	Must segregate any liquid assets sufficient to meet obligations equal to mark-to-market exposure amount (derivatives that net settle in cash) or full notional amount of obligation (derivatives that physically settle and CDS)	Must segregate cash or cash equivalents sufficient to meet obligations equal to: • Mark-to-market exposure for derivatives • Entire obligation for financial commitment transactions
Derivatives Risk Manager	No derivatives risk manager or risk management program	Must appoint derivatives risk manager if fund engages in frequent/complex derivatives transactions

RE-PROPOSED RULE ON INCENTIVE-BASED COMPENSATION

- Original proposal applied mainly to bank-related institutions
- Current proposal extends to investment advisers and broker-dealers
- Depth of requirements depends on size of firm
  - $1 billion to $50 billion (Level 3)
  - $50 billion to $250 billion (Level 2)
  - Over $250 billion (Level 1)

RE-PROPOSED RULE ON INCENTIVE-BASED COMPENSATION

- AIFMD/UCITS V “like” requirements
- Applies to incentive based compensation payable to “senior executive officers” and “significant-risk takers”
- For Level 1 & 2 “covered institutions”
  - Clawbacks
  - Deferrals (up to 60%)
  - Risk-monitoring framework requirements

Regulatory Initiatives Affecting Distribution in Europe

MiFID II

Product governance

Distribution

Distributor due diligence

Suitability / appropriateness

Independent / restricted advice labels

Inducements / commission prohibition

Product intervention powers

Key themes

- Know your target market and their needs
- Consider <u>all</u> product aspects (including charging structure)
- Scenario testing
- Ongoing assessment of product and distribution strategy
- Remuneration of distributors / sales staff / advisers
- Enhance suitability and appropriateness assessments
- Particular issues for “complex” products. (Brexit)

EC COMMISSION ON CROSS-BORDER DISTRIBUTION OF INVESTMENT FUNDS

- **Is cross-border distribution broken?**
  - Failure to harmonise marketing restrictions
  - Regulatory fees
  - Administrative arrangements
  - Online distribution
  - Notification process
- **Can it be fixed?**

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