Event Report

Developments in Fund Governance and the Regulatory Outlook

What managers and investors need to know

Held on Wednesday 14 October 2015

AT THE LONDON STOCK EXCHANGE

In association with

Newgate Compliance
INDOS Financial
Trinity Fund Administration
Simmons & Simmons
IPAF Group

Guest speaker

Susanne Gahler, Manager, Investment Management Sector Team, FCA Supervision Division

Developments in fund governance and the regulatory outlook

WHAT MANAGERS AND INVESTORS NEED TO KNOW

Developments in fund governance

PANEL:
Caroline Hoare, Director, IPAF (UK) Ltd
John McCann, CEO, Trinity Fund Administration

MODERATOR:
Bill Prew, CEO, INDOS Financial

Bill Prew: We are going to start by looking at developments in the fund governance arena. Governance has changed a lot over the last five years. Caroline, could you explain where you see the industry now and how things have evolved over the last few years?

Caroline Hoare: I'd say it's a tale of two parts. Undoubtedly many funds now take the issue of governance very seriously. We often find that when people are forming their boards the consultation process might involve up to 20 different people. But I do still get calls from people saying they've been offered a "buy-one, get-one-free" offer; those conversations tend to be extremely short!

BP: Most people recognise that progress has been made and there are boards that are particularly well run. Why do you think there are still boards that aren't run particularly well?

CH: When you are creating a board you need directors who are genuinely independent – independent of each other – and who have complementary skills. We find the people on our panels who are former COOs are particularly popular, especially with start-ups, for obvious reasons. You want complementary skills and genuine independence. If possible, avoid having people from the same 'director house' because they probably work together and might well give very similar views. A strong board and directors can really help in a crisis – I can tell you that from personal experience, having run a fund for 10 years. There were moments when I used to say, I don't know what I'm paying these people for on 364 days of the year, but on the 365th, I really do know! And on that day I expected a great deal from them. And I was very grateful for their input because they were good directors.

BP: I was at an event recently and there was a big focus on whether or not investors should be more involved in the director selection process – after all the investors are the primary stakeholders in the fund. Is that something that you buy into?

CH: On the whole I think it's probably not a good idea to have too much investor input into the choice of directors because that inevitably leads to a conflict of interest later on. If you've got a first seed investor who's put its own nominee on, is that nominee director going to take as much care of the subsequent investors? Besides, as a matter of practicality, you've often chosen your directors before the investors come in, so it may not be a practical solution.

On the other hand, where investors could really help is more time doing due diligence on the directors themselves. They should talk to them when they're doing their due diligence, if possible meet them. That may not be practical if they are miles apart, but at least talk to them. Something I feel very strongly about is they should ask funds the very significant question: "What do you pay your directors?" The answer to that question gives you two very important pieces of information.

The first is, are you paying your director enough that he/she is going to give the fund the commitment that the fund deserves? Secondly, it tells you how seriously the fund takes corporate governance. If the manager thinks that he can get a good director for $5,000 a year, it suggests that corporate governance is low down on his list of priorities.

John McCann: There are various compliance and governance edicts which provide quite a prescriptive framework of what the board needs to deal with (in particular in highlighted onshore domiciles). In recent years, during and since the financial crisis, you've seen real skill sets performed by independent directors. The composition of the board in our experience is gradually improving over the past few years since the crisis; this has been driven by a combination of commercial and regulatory demands, in particular in highly regulated domiciles. It's definitely improving at a faster pace generally, I think, onshore than it is offshore.

There are still instances where you need to provide a lot of support and, on occasions, education, but that's generally changing for the better, and I think all of the vendors have an interest in ensuring that the board does not consist of sycophants with a one-dimensional collective skill set. Having a variety of complementary and diverse skill sets is so important. Historically we have seen a lot of ex-CEOs, ex-fund administrators, ex-lawyers.

What, however, has been really lacking historically, but is improving recently, is individuals that possess risk management on the investment management side. The Cayman Islands has issued a statement of guidance on corporate governance which says there should be a minimum of two board meetings per annum. It also addresses what is expected in terms of custodial depository reports, admin reports, marketing reports, manager reports. Things are getting more and more prescriptive across all the major fund domiciles, not just the highly regulated ones.

CH: In Ireland, has anybody yet been told that they shouldn't take on a directorship or that they should shed some of their directorships?

JM: That's coming. There are a few Irish practitioners who have substantial portfolios of funds. Things may need to change as far as these practitioners are concerned, particularly if going forward every appointment has to be approved by the CBI.

CH: Ireland is really trying to get to grips with this issue of directorships and numbers of directorships, and Luxembourg is, I believe, also looking very seriously at the issue.

Things are improving but the progress is slow. One would have hoped five years ago that we'd be further down the road by now.

BP: Can you touch on the sort of things that can go wrong and why governance is so important?

JM: You start off a business with a view that it's going to be successful, but you need to plan for the eventuality that it is not successful. The conflicts question permeates our industry again and again. You can see from past blow-ups where similar entities or people perform different roles for a given fund, reducing or even eliminating "checks and balance".

If a director is connected to the investment manager, that is a prime example of a concerning conflict. To explain further and provide an example of the importance of truly independent directors, there was a famous case in 2008, pre-Madoff, involving sub-prime investments, where a former leading American Bank, which is no longer with us today, had a high-yield fund. It was a substantial master-feeder structure, with feeder funds in the Caymans, and three master funds domiciled in the US. Only one of the feeder funds had an independent board. All of the other boards and key functions were performed by people connected to the American bank. As the whole thing was unravelling, they couldn't get any proper values at the master level, but up at the feeders the asset managers and their product people wanted to keep the Cayman pricing/dealing ongoing without suspension, which would have been commercially and reputationally damaging to the American bank. So they kept putting pressure on the Cayman funds to put a valuation out.

The only one who said no was the independent director at one of the feeder funds in Cayman, who logically asked this question: "How can we value if we

cannot price the underlying securities?" This question initiated the unravelling of the whole scheme. If it was not for the actions of the independent director, the losses could have been far worse.

As a result there's no question that the manner in which the board is comprised, having experience in distressed situations, is critical to mitigating conflicts and potential losses. These questions should be on a due diligence questionnaire, e.g., Have you sat on a board that has been wound up? Have you sat on a board that has had some trouble and gone pear-shaped? How have you dealt with this situation? Did you just go to the professional liquidator and resign before doing all you could in your fiduciary duty?

BP: When we focus on fund governance we tend to focus on the board of the fund. But governance is broader than that and includes vendor management. Partly driven by regulation such as AIFMD, there is an increased focus on risk management and how managers review their service providers' arrangements, and the interaction between service providers and boards of funds. John, as a service provider, can you share your thoughts on how your world has changed in this regard?

JM: Things have changed greatly. We used to be asked two questions: what are our fees, and can we do this business? If the answers were the right ones we were off and running.

Now we are involved in extensive due diligence exercises that focus on things such as our IT capability, our data-delivery capability and our human capital. Prospective clients now ask searching questions on service and senior managers. They ask who is on the account and what sort of experience they have in supporting their strategy. They ask for client references. They want to see our ISAE 3402 controls report. They ask us about our own business strategy, especially as we are an independent provider. They want to know about the possible impact of a change of ownership, as there is a lot of M&A activity in the administration space.

There is a lot of investigation at the beginning of the business relationship and on an ongoing basis. Our managers are performing detailed annual reviews over us, whereas before this would be periodic (if at all).

There have been other significant changes. Historically at annual audit time, we would supply the respective auditor with unaudited management accounts and they went off and prepared all of the financial statements, inclusive of the lead schedules, book and cash reconciliation disclosure notes, technical requirements in accordance with the relevant accounting standards, etc. Now we prepare all the 'full blown' sets of accounts, all the supporting documentation. The expansion of the financials is obviously quite substantial and changing all the time in relation to accounting standards such as US GAAP or IFRS. The audit has become more focused on the risk environment, on our business controls, our automation. We have fund compliance people, directors and regulatory MLROs (money laundering reporting officers) from the funds asking detailed questions of us on a regular basis.

As mentioned, we are not part of a financial family; we are truly putting forward independence as our firm's USP. We work with 30-50 different international financial institutions in many different areas, such as banking, broking, audit, etc., and sometimes we may introduce a client to them and they decide whether they want to go with the client. However, because we're doing the AML at the shareholder investor level, as an approved introducer, we have obligations to them to provide information and reporting to them in terms of the continuous due diligence under the various global AML directives that have come out in recent years.

Moving on from these developments in respect to the clients or other service providers, it's definitely now also investor-driven and involved. Obviously the principal in accordance with best practice wants to please his seed or key investors, but also on an ongoing basis to preserve capital. So the number of interactions that we would have with that investor has increased exponentially. This increased focus and "deep dive" by institutional investors in terms of evaluation of the fund's "key vendors" has changed the whole industry. Now, whether they're involved in influencing decisions made by the fund's board, or whether they're insisting on minimal disclosure in terms of the reporting they require, the manner and detail in which we report to them has altered significantly. We used to recommend to our offshore funds to have regular board meetings, with us presenting a detailed fund administrator report. An example of this would be the granular level of detail we would present covering key operational aspects of our administrative duties since the last board meeting. Thankfully most funds now hold proper, substantial board meetings, whether prescribed by the regulator or not (e.g., Cayman offshore funds) which is a good thing from our point of view.

At this meeting it is now standard to have the custodian present a report, the investment manager, etc., to present a report and so on. In Ireland, for example, what is required to be discussed is quite prescriptive. We do that four times a year for Irish funds; we do it on average two, up to three or four for Cayman funds, depending on the fund, because it costs money from a corporate secretarial perspective. So there's a continuous and widening engagement with all of the stakeholders into the fund, which is not, from our point of view, necessarily a bad thing.

I do think in some areas that there may be some overlap, there may be some ways to be more efficient, but there's no doubt that the fund governance process has fundamentally changed for the better overall. Back to investors – they want to look at how the valuation and the pricing policy is done. They want to know who has authorised control over the bank accounts and who's signing. And so it's becoming quite granular and it's now extremely detailed and wide-reaching. There is an industry framework and a regulatory expectation of a wide range of key operational trading, risk and compliance matters to be constantly addressed for various interested parties into a fund's affairs.

BP: So do you think there's enough service provider oversight from fund directors?

JM: Hard to say. We've had two instances in the last year where directors have come to us to do a due diligence visit. But the question I would ask is, do they have the skills to evaluate us? I think some might, but not all of them that we have come across. One example we might raise here to illustrate the point is cybersecurity. We get asked about this almost daily these days. It's permeating everything, and as a theme it runs all the way down the supply chain and the entire data vendor management.

Recently the SEC has fined a firm; that firm didn't lose anybody any money, but they didn't have a proper cybersecurity policy in place in relation to a designated third-party to whom they outsource some services which they still had overall responsibility for.

We are getting asked about our encryption policy, and do we have a secure FTP? Have we done penetration testing? We are asked about our inventory of data, how many third-party vendors do we use? Trinity is a very limited user of third-party vendors (IT or otherwise); i.e., we don't use cloud services very extensively. We host our own client data portal and web site inside our firm. We have greater control over the indirect risks presented in this area compared to other large firms who outsource significantly.

What is clear these days (and confirmed via recent international regulator enforcement cases) is that we have responsibility all the way down the supply chain. So we now go and inspect our IT provider in respect of the back-up services they provide for our DR (disaster recovery), our business continuity and our back-up. We have to see them at least once a year.

So is there enough oversight? I think there's oversight in a variety of different ways. In recent years it has

been increasing from all of the fund stakeholders, including the directors. I think directors should be asking for greater information, not to give the manager assurance, but because they are an independent director and the role demands it. That is becoming very topical and is very much part of the greater discussion at board levels. Most directors are doing this at present because investors are increasingly demanding this.

CH: At a recent fund board meeting, we asked for a report both from the administrator and from the investment manager on their cybersecurity tests.

The Regulatory Outlook

PANEL:
Susanne Gahler, Manager, Investment Management Sector Team, FCA Supervision Division
Simon Whiteside, Partner, Simmons & Simmons
Nick Colston, Partner, Simmons & Simmons
Martin Herriot, Director, Newgate Compliance Ltd

MODERATOR:
Bill Prew, CEO, INDOS Financial

BP: We're going to kick off by asking Susanne to set the scene and explain the role of the Investment Management Sector Team at the FCA and their areas of focus at present.

Susanne Gahler: The Investment Management Sector Team provides technical advice and all-sector expertise to supervisors that are engaging with the investment management industry; this includes asset management, including the alternative sector. We also own the so-called risk map for the sector. That means we are responsible for identifying the key risks and leading on the mitigation actions. We also provide technical advice to all the international debates that the FCA is engaged in that relate to asset management, including the hedge fund industry.

On the subject of fund governance, hedge fund managers, like all other financial institutions, face an inherent conflict of interest. They are on the one hand commercial entities that are responsible to their shareholders and investors, and at the same time they must act as 'good agents' on behalf of their investors.

Interestingly, in the hedge fund industry this conflict was probably fairly reduced when the industry started out; the shareholder was often also the investor. But as the hedge fund industry becomes more mainstream and as it opens up to outside investors, institutional investors in particular, this kind of conflict will be much more prominent. Corporate governance is essentially the whole system of rules, practices and processes that actually ensures that this conflict is well managed.

There are three main sets of actors that have a role in ensuring that you have a proper fund governance in place: these are the authorised corporate directors (ACDs), whether they're insourced or outsourced; the depositary and trustees; and finally the independent auditors.

The FCA would like the ACDs to be empowered and challenging on behalf of investors. The depositary and trustees fulfill the very important function of oversight of managers – a key role in valuing assets, dealing, making sure that investment and borrowing restrictions are met.

The FCA is very keen to leverage the depositary oversight to oversee the industry as a whole, and to use independent auditors to ensure there is a clear and fair view of investment positions and appropriate product mix.

The FCA has a very sharp focus on fair investor outcomes and explicit standards of consumer protection. This includes product governance, so we're not only talking about fund governance, but also product governance, and whether these products are appropriately targeted and whether managers actually appreciate that they have the right tools in place to manage the liquidity of their funds to correspond to the assets.

18 months ago the FCA created a separate fund supervision team which looks at funds. It's also authorising funds at the same time and it particularly monitors depositary reporting. This team has launched a "Meeting Investors' Expectations" thematic review. The review assesses whether UK authorised investment funds are operated in line with investors' expectations as set by marketing material, disclosure material and investment mandates. The FCA also considered how firms checked that funds were being appropriately distributed. The second big theme was launched by our new competition department; that was announced earlier in the year and essentially that market competition study looks at whether the industry functions effectively. It will look at the structure of the industry, it will look at the incentives that are in place to create competition, and it will also look at ancillary services that are attached to the industry.

Another key area of focus has been AIFMD. It's a brand new directive and my team is responsible for implementing the reporting requirements and monitoring the reporting. It's a huge effort, not only by the industry but also by the FCA. It was a stretch for our systems and also our analytical capabilities.

We often get asked the question, what will you do with the AIFMD data you collect? I think we first have to inject a bit of reality here. When the US introduced Form PF I think it took them about two years to extract really targeted and useful information. We have now had one year of implementation; I think it will probably take us another 12 months to really effectively use this data.

There is of course a lot of debate internationally about whether hedge funds pose a systemic risk and therefore need to be designated in some form for special regulatory oversight. It's an interesting debate. The FCA certainly participates in that debate, but it's mainly led by central bankers.

I think a big challenge is to actually explain that hedge funds are not banks and the risks that they may imply are not necessarily bank-like risks. I think we have made some progress in that there is some recognition on the side of the FSB that hedge fund activities may be perhaps systemic, but not the hedge funds themselves, and I think this is an important differentiation.

There's quite a bit of ongoing work on these issues and I would think that in 2016 there will be further clarification by some of the international bodies, such as IOSCO, on how they will approach this topic.

BP: Martin, as a compliance consultant supporting managers through all this regulatory change, could you share some thoughts on what you're seeing, and on what managers are doing and focusing on?

Martin Herriot: A lot of the issues faced by firms at the moment originate from the new directive – the AIFMD.

One of the major areas causing issues is marketing. We were told that the AIFMD would make marketing easier throughout Europe. But as we now know managers have first got to ask themselves a series of questions; are we an EU manager or a non-EU manager? Are we an EU fund or a non-EU fund? Are we a small AIFM or a large AIFM? Are we going to be able to use the marketing passport? Do we have to rely on the national private placement rules? These questions are causing firms to ask themselves whether or not they can do some or all of the marketing they wish to do.

A number of firms are relying on the reverse solicitation rules, but there is some concern over the use and application of these rules. You've got to be able to show that the first approach was made by the investor to you, the manager. My advice to managers

is be careful and maintain good supporting evidence and audit trails relating to all investor and marketing activity.

Another key area is compliance and monitoring. The effects of the AIFMD should be embedded into your compliance and monitoring. You must know what has to go in an annual report so that you can undertake the necessary monitoring. There are a number of things arising from the AIFMD that you need to be monitoring and including in your annual report. We're finding a lot of firms, when we go in to see them, aren't including certain things in their monitoring process so, as a consequence, things are getting missed. There are seven or eight different areas that you should be monitoring on a fairly regular basis, and we're not seeing that in all cases.

A word on Annex IV reporting. If you're a large firm, and you've been doing your Annex IV reporting quarterly, you're probably used to it by now. However, if you are a small alternative investment fund manager you've had a year now to prepare, so you should be looking at where you're going to get the information from ahead of your next filing. Also firms should ensure they have submitted all FCA material change notifications that may have been required.

Amongst the hot topics that we see from our interactions with the FCA, not unsurprisingly, governance looms large, with questions being asked like how many directorships your directors have. What skills are on the board? What's the make-up of the board?

It is felt that what's happening (or not happening) on the governance side will 'permeate' through the firm. I've yet to be on the other side of a FCA visit where they haven't been talking about governance. Governance and directorships is a thread running through lots of things so you ought to be looking at your corporate governance and the control structures at your firms.

Another hot topic is conflicts of interest. Make sure you've got a conflicts of interest register, make sure you've got a conflicts policy, and make sure your people know about that policy. 'Conflicts' has had the spotlight on it for at least two or three years now. You really ought to be on top of it and when it comes to conflicts, remember the investor must come first.

All these things shouldn't be new to anybody, and yet you'd be amazed at the number of firms who haven't given it much thought yet.

Something that's emerging is Fintech. A number of firms are now using technology to do certain things, and to try to speed things up. In our experience we have seen the FCA be quite robust in checking the depth and the ability of technical solutions designed to replace things that were being done by a person.

That brings me on to the big thing going forward: namely, MiFID 2. We don't quite know yet whether or not the regulator is going to gold-plate MiFID 2 onto the alternative investment fund industry. There is still some way to go – the rules have only just gone from ESMA to the European Commission, and that was at the back end of September – but this also needs to be on your radar.

BP: Simon, perhaps you could share your thoughts on AIFMD: where are we now and what is the outlook?

Simon Whiteside: The passport and the debate about the extension of the passport is the most topical thing, I think. ESMA has said that Guernsey and Jersey are acceptable, and Switzerland would be if it makes a couple of tweaks. But it has said no to Hong Kong and the US.

A statement has said the second wave of extensions would be put in place. If you look at ESMA's timetable for 2016, that's not timetabled until Q4 so, if they're going to stick to that, that would mean they are not going to get round to reporting on the Cayman Islands (for example) until the end of next year.

We don't yet know whether the Commission is going to extend the passport to Guernsey and Jersey now, or whether it's going to, as ESMA suggested, wait for more information, which would mean another 12 months at least until we see a passport for any third country. If ESMA and the Commission stick to the way AIFMD is drafted, that means another year until we can start thinking about whether or not we are going to be living with three more years of private placement.

At the moment, for non-EU funds, it's a case of private placement as usual, and it's becoming more prevalent as we see managers becoming more and more frustrated with the restrictions and risks associated with reverse inquiry.

BP: I gather ESMA may review different interpretations of the marketing rules and registration processes which could lead to more uniform approaches being taken across Europe, or at least that was one of the areas that was highlighted in the ESMA recommendation/opinion to the Commission.

SW: The different approaches being taken across Europe are frustrating for everybody. Registration takes a day in the UK, but it can take up to six months in Germany. It should also be remembered that, even if you do get a passport, it's going to be similar to national private placement rules insofar as there are going to be tweaks and variations from country to country.

BP: With MiFID 2 due to come into force in about a year's time, namely in January 2017, we're going to turn our attention to the next significant piece of legislation coming into force. Nick, there are a few headline things about MiFID 2 that every manager or investor should be aware of. Can you run through these?

Nick Colston: MiFID 2 is at quite an interesting stage in the implementation and development process. Having spoken to a number of my clients, there are asset managers out there who are very far advanced in MiFID 2 implementation projects, doing gap analysis and impact analysis work. On the other hand, there are some people who may not yet have even started to engage with what MiFID 2 is and why it matters to them and their organisation. I'd like to explain what it is and why it matters, and then we can drill down into some of the key topics from an asset management perspective.

MiFID is the Markets in Financial Instruments Directive. It's the foundational piece, the core framework for European financial services regulation. It touches investment management, banking, brokerage businesses, private banks, investment banks, exchanges and other trading platforms. The original MiFID, which we're now calling MiFID 1, came into force in 2007, and we've got some very substantial revisions to that regime which we're calling MiFID 2 which will come into force on the 3rd January 2017[1].

It's a very big revision to the existing financial services framework and there are some open questions as to the extent to which it's going to be gold-plated onto firms that are now authorised under AIFMD or authorised under the UCITS Directive.

Our assumption at the moment is that most, if not all, of the key conduct requirements and reporting requirements under MiFID 2 will either immediately, or ultimately, be gold-plated to, in particular, AIFMs. But even if that doesn't happen there are large parts of MiFID 2 that will have an indirect impact: for example, changes to the way that some of the markets are being regulated and how the brokers and other market participants are required to interact with their customers, which will include asset managers and impact those operating in the asset management space.

Drawing out a couple of key topics, one that has received a lot of press and a lot of people talking in the last year or so are the changes to the inducements rules, which have a knock-on effect in particular for

asset managers paying for investment research.

There are already inducements rules in MiFID 1 and the FCA already has its dealing commission rules for payments for research in the equity space. But MiFID 2 quite substantially restricts the situations in which portfolio managers are permitted to receive inducements, in other words fees, commissions and non-monetary benefits from third parties.

The trouble for the asset management industry, potentially, is that in one of ESMA's consultation papers it interprets all investment research as a non-monetary benefit.

So if you're receiving investment research from the sell side it's caught within these new inducements rules, and what ESMA has effectively said is if you are a portfolio manager, or an asset manager, and you want to continue receiving investment research you can only do that in one of two ways. You either pay for it in hard dollars or you agree what are called 'research payment accounts' with your clients, so your clients pre-fund an account and you can draw down from that account to pay for research.

It is important to emphasise a couple of things. You will notice I've not mentioned any use of soft dollars or dealing commission. ESMA's proposals would appear to prohibit the current soft dollar dealing commission model to pay for investment research, which will be a big change for equity-focused funds that use that model at the moment.

The other point that is worth mentioning is that it is not about how you pay for research, it's about the receipt of research. This could impact the fixed income world as well. Today, the fixed income world wouldn't typically use a dealing commission soft dollar model to pay for research. Instead it would just be priced into the spread paid for particular instruments. This might have to change; the cost would have to be un-bundled from the spread and a hard dollar cost paid for the research.

These proposals proved very unpopular with the governments of the UK, Germany and France, all of whom joined together and wrote to ESMA to say, "Sorry ESMA, you've got this completely wrong, that wasn't the plan, that wasn't the intention of MiFID 2; investment research wasn't supposed to be considered a non-monetary benefit and you've gone off on the wrong course". So with that very high-level political pressure coming from the UK, France and Germany we may see a bit of movement of the final position.

The second topic to mention is transaction reporting and post-trade transparency. One of the things that we are trying to emphasise with MiFID 2 is that it's not just a re-papering exercise. To a large extent the implementation of AIFMD was something that legal and compliance professionals could handle by putting in place new contracts, new agreements with service providers, new internal compliance procedures, etc. By contrast, with MiFID 2 there are a lot more 'nuts and bolts' behind the scenes, more operational and technological jobs that need to be done. Transaction reporting is a good example of this.

> "MiFID 2 extends the responsibilities for product providers and distributors in the retail space, from a product governance perspective, to the professional space. It will force fund managers to think of themselves not just as portfolio managers but also as product manufacturers."

Transaction reporting is an obligation contained within MiFID 1 that requires you to report all transactions in reportable instruments to the FCA. However, when the FCA brought MiFID 1 into force back in 2007 a very generous exemption for portfolio managers was introduced. So if you are a portfolio manager trading with a broker or counterparty who is themselves subject to the transaction reporting obligation you don't have to do the report yourself; you rely on your counterparties to do it for you.

What's changing with MiFID 2 is that the portfolio manager exemption will cease to exist, and instead we will have a slightly narrower and probably much less useful exemption for order transmitters.

If you are transmitting an order to a broker for that broker to execute it for you in the market, you can rely on their report in that situation, but there are a couple of pre-conditions in order to benefit from that. First of all you have to have a formal written agreement in place with that broker that sets out how they'll do your reporting, and secondly you'll have to transmit a fair amount of information to them to enable them to do your report for you.

The exemption only covers order transmitting. It doesn't cover executing orders directly in the market, so if you use DMA software to execute directly, or if you're trading with someone who's trading OTC or off their prop book where you are executing rather than transmitting, the exemption won't apply there, and so you as a portfolio manager would have to do your own reporting.

From talking to my clients, there's a sort of very reluctant or defeated acceptance that hedge fund managers will end up having to do some transaction reporting, and there's a growing line of thought that by the time you're doing some transaction reporting, rather than doing some reporting yourself and then some reliance on the transmitter exemption, is it just operationally more straightforward to do all the reporting yourself?

In order to fulfill your transaction reporting obligations, your trading system needs to be capable of reporting to the FCA details of all the trades that you execute or carry out on behalf of your clients. There are 65 separate fields that have to be reported, and that includes an identity code for each individual portfolio manager within your organisation who made the trading decision, and an identity code to represent the trader who actually executed it.

In addition, you have to be able to do real-time short or long flagging; so you have to flag each trade on a trade-by-trade basis as being net short or net long. That is quite a big operational issue. If it is not something you currently do you will need to build a system that is capable of doing that and that feeds into your trading system, and that can feed the reports to the FCA. That is going to be a big work stream; and it's not really a compliance work stream. It's something that you need your technology and operations teams doing.

But it's not just what you have to report on; there are also some record-keeping requirements as well that

you have to maintain which, as I understand it, could result in an increasing shift away from telephone conversations towards automated trading. You will have to make an immediate record of every trade that you execute, and there are a couple of dozen fields that you have to record immediately. There's a logistical operational challenge if you use voice broking at the moment. If your trader is doing their trades over the phone, how do you immediately record X number of details if you're frequently trading on the phone? So does that mean that every trader, or the traders generally, need a full-time desk assistant who is recording the immediate details of every trade that they've put through on the phone?

There is a telephone taping requirement that the FCA already has in place but again there's a very generous portfolio manager exemption. That exemption won't be able to continue once MiFID 2 comes into force, so all portfolio managers will have to tape all trading lines.

Pre- and post-trade transparency is being extended from the equity world into the fixed income world as well. Within a couple of minutes of a bond trade or another fixed income instrument being traded is a requirement to publish the trade to the market in the same way that an equity trade would be today. What is currently a very opaque market, where you are relying on dealer runs and other sorts of informal methods of getting pricing for fixed income instruments, should become a more transparent market, which is a very big change to the way that market operates. So there's a question again within your organisation, if you're a fixed income house, are your traders and portfolio managers aware that this change is coming down the line?

As you can see, there are a lot of operational market infrastructure-type of rules that are changing, and that will impact asset managers.

Finally, I want to briefly mention product governance, which is something that Susanne already mentioned in the context of the FCA having carried out a thematic review over the course of this summer on product governance issues. Product governance is a concept that, if you are a retail fund manager or you've got UCITS products, you'll have come across before. But if you're a pure alternative manager it may not be something that you've particularly engaged with.

MiFID 2 extends the responsibilities for product providers and distributors in the retail space, from a product governance perspective, to the professional space. It will force fund managers to think of themselves not just as portfolio managers but also as product manufacturers. The regulatory regime will be such that you need to have identified a target market for your products. So who is the target investor for a hedge fund? It will be quite interesting to see what that description ends up looking like, but you will have to identify it. For example, pension funds, sovereign wealth funds, ultra-high-net-worth individuals, what are the needs and demands of these different types of investors and how does your fund meet them? And I think that's going to be an interesting cultural shift for fund managers to start to have to think of themselves as product manufacturers in the way that perhaps a UCITS fund manager does today.

SW: If you are both a manufacturer and a distributor there is a lot of overlap. But what if you are employing third-party European distributors? They are going to be looking at your target market, making their own assessments, having their own compliance requirements and then requiring information from you so that they can tick all their boxes on the distributor product governance part.

It also means that if you are an AIFM and the FCA decides not to gold-plate MiFID 2 so that it doesn't apply to that part of your business in relation to product governance, those distributors will require a written agreement from you because they will have to do a lot more of the leg-work to identify a target market because you, as a non-MiFID firm, won't have done that.

In addition, many dark pools will become 'lit up'. The waivers for post-trade transparency are reducing, or being narrowed, and there is also a double volume cap mechanism in place which means that if certain thresholds are exceeded in relation to financial instruments, a dark pool will become lit up automatically, and that can be either because of what you're doing, but maybe perhaps from your scale it can actually be due to the fact that someone else has joined in trading that instrument and you have passively exceeded the relevant limit.

There's a lot of thinking to be done, not just about your compliance obligations, but what everyone you're working with is doing on the compliance side and what they're going to ask you for, in order that they can comply.

Whilst it's very frustrating that we don't know what MiFID 2 is going to say in respect of a lot of these things, there is enough to be going on with and enough to merit you reaching out to your brokers and your other counterparties to start inquiring of them, where are they with their MiFID 2 implementation plans, and what do they think they're going to be looking for?

I want to touch on one more topic, namely algorithmic and high-frequency trading and direct electronic access, because this is new to MiFID 2. While it was ostensibly brought in to address concerns around the 'flash crash' and high-frequency trading, the definition of algorithmic trading basically means if you use an algorithm in any part of your investment process you will be an algorithmic trader.

For example, the net is so wide it means that not only will all the quantitative managers be brought in scope, but firms which don't actually use an algorithm to trade but use smart order routers to place trades will be in the scope of algorithmic trading.

In contrast, an automated router won't be caught, but depending on how you use that automated router and where it lies you may be subject to your broker's requirements as a direct electronic access (DEA) provider. The providers of DEA services will have to perform extensive due diligence on you; a written agreement is also required. Because DEA providers will take regulatory responsibility for you, they will try to offload that onto you under these agreements.

This means that any sort of electronic trading may put you in the scope of the additional compliance burden which is quite extensive, so there are systems and resilience requirements such as kill functions and throttles. The compliance officer will have to be trained and they are required to understand algorithms and to perform real-time monitoring. The list is long and the burden is heavy; record-keeping is key so that if the FCA comes knocking you can actually show them that you've been compliant.

BP: Based on the current timetable for implementation, managers have got just over a year to get their house in order to be compliant by January 2017. There's an awful lot to cover.

SW: The timetable that's been mooted is that the final rules will be in July 2016, and then you've got six months. Things might change between now and July, but we've got the gist of most things. I still think there's a bit of horse trading going on behind the scenes. **THFJ**

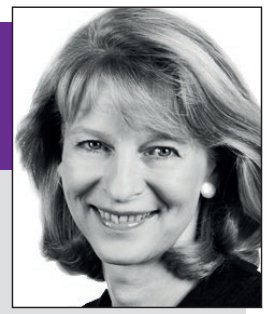
FOOTNOTES

1. Since the date of the event, following pressure from legislative and industry bodies to delay the implementation of MiFID 2 implementation has been delayed until 3 January 2018. Nevertheless, managers are encouraged to continue with MiFID 2 implementation projects, as many sources agree that even this delayed implementation date will not be without challenge.

Speaker Profiles

Developments in Fund Governance and the Regulatory Outlook

What managers and investors need to know



Caroline Hoare
Director
IPAF (UK) Ltd

Caroline Hoare is one of the founders and a director of IPAF (UK) Ltd, a company providing non-executive directors to alternative funds. IPAF has a panel of directors — mainly in offshore jurisdictions — who have all had careers in the funds industry. Hoare is resident in the UK and is a lawyer and former hedge fund CEO. She joined GNI Ltd, the futures and options broking arm of the Gerrard Group, in 1994, later becoming a director of GNI Fund Management Ltd, the Group's alternative funds business, before joining hedge fund GLC Ltd as its CEO in 2001. She held this position for 10 years and served on the GLC board. In 2010 she was named as one of the 50 Leading Women in Hedge Funds by *The Hedge Fund Journal*'s biannual survey and was recognised by *Financial News* as one of the 100 Influential Women in Finance working in European financial markets. She now serves as a non-executive director to hedge funds and UK financial institutions.

Susanne Gahler
Manager, Investment Management Sector Team, FCA Supervision Division

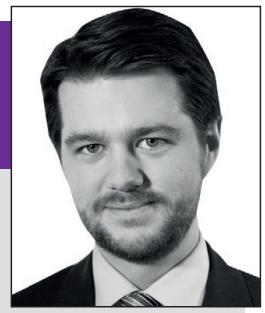
At the FCA, Susanne Gahler oversees the work of the sector team in the Investment Management Department, which is responsible for the supervision of asset and wealth management firms and investment funds, private banks and CFD providers. The sector team plays a key role in identifying and mitigating the risks that emanate from investment management activities. It provides technical expertise on all investment management issues to the FCA's Supervision, Policy and Senior Management teams.

Prior to joining the FCA in early 2011, Gahler gained her investment management, financial and market experience as a fund manager, fixed income and currency strategist, and economist in London, working with F&C Asset Management and J.P. Morgan. She started her career at the Inter-American Development Bank and Institute of International Finance in Washington DC.

John McCann
CEO
Trinity Fund Administration

John McCann is the CEO of Trinity Fund Administration, a global fund services company providing administrative, risk and regulatory reporting, transfer agency, company register and corporate secretarial services to funds and investment vehicles incorporated in a variety of jurisdictions. Trinity's head office is in Dublin. It also has an office in the Cayman Islands and business development representatives in New York, Brazil and Cyprus. McCann has over 30 years of experience working in global financial services in London, Jersey, the Cayman Islands and Dublin. He has served on several committees of the Irish Funds Industry Association including the Alternative Investments Committee and its separately established task force which was dedicated to a balanced implementation of the AIFMD. He is a current member of AIMA's AIFMD working group/panel of experts and a member of their AIFMD reporting forum.

Nick Colston
Partner
Simmons & Simmons



Nick Colston is a Partner in the Financial Services group at Simmons & Simmons in London, and has been with the firm since 2005. Colston specialises in advising financial sector firms on all aspects of the UK and EU regulatory regimes. His primary focus is advising alternative fund management firms (both in the UK and globally) on financial regulatory issues including MiFID, AIFMD, compliance with the FCA Rules, client documentation, compliance policies and procedures, market abuse, money laundering, other anti-financial crime requirements and cross-border business. More broadly, Colston's clients include asset management firms, family offices, investment banks, private banks and brokers. He is currently advising firms across the industry on the implementation of MiFID 2 in the UK and EU, including carrying out impact analysis work and implementation projects for many leading asset management firms.

Bill Prew
CEO
INDOS Financial

Bill Prew is the Founder and CEO of INDOS Financial, an independent AIFMD depositary with offices in London and Ireland. Since becoming the first AIFMD depositary to be authorised by the FCA in January 2014, INDOS has grown its client base to over 35 alternative investment funds representing assets in excess of $5 billion, covering a range of strategies from hedge funds to private equity funds, and open and closed-ended fund structures. Prior to establishing INDOS in 2012, Prew held roles including COO of the hedge fund James Caird Asset Management, and European CFO then Head of Supplier Management at Barclays Global Investors. Prew is a recognised independent expert on AIFMD and has presented at many industry events and been published widely in the industry press. He qualified as an accountant with PwC in 1997 and has a degree in Economics from the University of Manchester.

Martin Herriot
Director
Newgate Compliance Ltd

Martin Herriot is Managing Director of Newgate Compliance Limited. He has worked in the financial services sector for more than 25 years.

His experience includes over a decade at the FSA and its predecessor IMRO, five years as a CEO of a multi-national consulting firm and industry roles at Jupiter Asset Management, Barings, The Royal Bank of Scotland and Govett Asset Management.

While at the FCA/IMRO, Martin held a number of senior positions leading teams of supervisors undertaking monitoring visits, was a voting member on the Regulatory Transaction Committee and had decision-making authority on all types of investment management authorisation applications. He was also the investment management specialist for the Regulatory Transactions Department.

Simon Whiteside
Partner
Simmons & Simmons

Simon Whiteside is a Partner in the Financial Services group at Simmons & Simmons in London. He is an investment funds specialist, focusing on structuring and re-structuring hedge funds, single investor funds and managed accounts, as well as advising managers on their investment product ranges and regulatory compliance issues, including in relation to AIFMD. Recent work includes advising US firms on the establishment of London-based affiliates, as well as on marketing their products in the EEA under AIFMD. More recently, Whiteside has been advising hedge fund manager clients, both in the UK and the US, in relation to the forthcoming implementation of MiFID 2, and is a member of Simmons & Simmons' MiFID 2 implementation team. Whiteside is a also member of the core team dedicated to start-up hedge funds which is also behind Simmons & Simmons' LaunchPlus — the firm's online resource for start-up hedge fund managers.